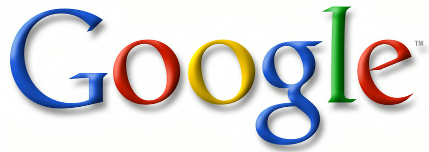

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THE SECURITIES AND EXCHANGE COMMISSION AUTHORIZATION ACT OF 1997

P15-79

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS

OF THE

COMMITTEE ON COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

MARCH 6, 1997

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THE SECURITIES AND EXCHANGE COMMISSION AUTHORIZATION ACT OF 1997

THURSDAY, MARCH 6, 1997

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:26 a.m. in room 2322, Rayburn House Office Building, Hon. Michael G. Oxley (chairman) presiding.

Members present: Representatives Oxley, Gillmor, Bilbray, White, Cubin, Markey, Manton, Deutsch, Wynn, and DeGette.

Staff present: David Cavicke, majority counsel; Linda Rich, majority counsel; and Consuela Washington, minority counsel.

Mr. OXLEY. It's with pleasure that I welcome Chairman Arthur Levitt, Commissioner Steve Wallman, Commissioner Isaac Hunt, and Commissioner Norman Johnson to the subcommittee to consider the reauthorization of the Securities and Exchange Commission.

The SEC is charged with the supervision of our financial markets, the protection of investors, and the promotion of efficiency, competition, and capital formation.

In carrying out this charge, the SEC helps to make the American public markets work more effectively, and in so doing promotes job creation by small businesses and economic growth for all Americans.

I'd like to commend my friend, Tom Manton, the ranking minority member of this new subcommittee. I look forward to working with him and all of the members of the committee to seek bipartisan solutions to some of the issues facing our markets today.

I would also like to commend our Chairman, Tom Bliley, and thank him for his leadership on financial services issues, as well as John Dingell, the ranking minority member of the full committee, for his many years of activity in this area. And finally I'd like to commend our friend, Ed Markey, former chairman of behalf of this subcommittee, and look forward to his continued leadership on issues affecting our financial markets.

I'm pleased to note that the performance of our financial markets—a vibrant stock market that has raised trillions of dollars from American business for American business, and the unparalleled access that Americans have to participate in these markets through mutual funds, 401(k) plans, and direct investment in stocks and bonds.

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It is the substantial freedom in which market participants conduct their affairs that I believe contributes to dynamic innovation and risk-taking, which are central to the capital formation process.

I believe the SEC has contributed to this process by letting the market create new products unshackled by regulatory burdens, while at the same time vigorously pursuing those who engage in fraud.

Under Chairman Levitt's leadership the SEC worked cooperatively with the committee, which, on a bipartisan basis, passed the National Securities Market Improvement Act, which was enacted into legislation last October—as a matter of fact, the last bill, I think, passed in the 104th Congress.

The Improvement Act made a number of important changes to the securities laws, including providing for exclusive Federal registration of a wide range of securities offerings, lowering the cost of borrowing for broker dealers, and providing for cost/benefit analysis of SEC rulemaking.

I would like to thank Chairman Levitt for his assistance on this important legislation, and we look forward to constructive discussions with and oversight of the SEC as we seek to implement the Improvement Act's important changes.

I intend to introduce legislation to reauthorize the Commission in these 2 fiscal years. A discussion draft of this legislation is before each one of the members. We will be working on a bipartisan basis to see that the important work of the Commission continues to receive adequate funding.

In that respect, we will all be building on the work that Chairman Bliley accomplished in the last Congress, working with Hal Rogers of the Appropriations Committee, Bill Archer of Ways and Means, and John Dingell and Ed Markey in providing a stable funding plan for the SEC that over the next 10 years will reduce the surplus in fees collected by the agency above the cost of running the SEC.

There are a number of issues that I think merit our attention as we consider the reauthorization of the SEC.

The SEC has requested authorized funding levels of $320 million in fiscal year 1998 and $342.7 million in fiscal year 1999.

We would like some additional background on the plans the Commission has for the agency in the next 2 years.

In addition, pursuant to changes under the Improvement Act, the SEC is required to consider efficiency competition and capital formation in its rulemaking. This important new requirement is, I believe, a constructive way for an agency to conduct cost/benefit analysis of its rules.

We hope that this analysis will serve to improve SEC rules, lowering regulatory burden on business and seeking to raise capital to create new jobs, and improving the general acceptance of SEC rules and the issue or community at large.

The Commission is working with the Financial Accounting Standards Board to develop new accounting treatment for certain derivative products. The United States is a world leader in over-the-counter derivative contracts. There are over $12 trillion in national principal amount of these privately negotiated contracts issued by U.S. dealers. Preventing regulatory burdens that would di-

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minish the utility of these contracts to business seeking to mitigate risk is an important goal for all of us.

I want to stress to the Commission the importance of ensuring that any accounting proposal be structured in such a way as to minimize disruption to these vitally important contracts.

Pursuant to both the Private Securities Litigation Reform Act and the National Securities Markets Improvement Act, we achieved, on a bipartisan basis, significant modernization of the laws governing our financial markets. In this Congress, I believe that some consideration to both the role and the rules of the self-regulatory organizations, like the New York Stock Exchange, the National Association of Securities Dealers, and the American Stock Exchange, would be beneficial.

The SROs, as they are known, provide a useful service to the markets by allowing market participants to police themselves, which is efficient and saves the Government money.

In the course of this self-regulation, we want to make sure that the exchanges are not erecting rules that are designed to protect their members from competition or disadvantage public investors.

In particular I am concerned that exchange rules that mandate trading in fractions are both antiquated and not in the interest of public investors.

I have read with interest that the Toronto Stock Exchange has modernized by converting from trading in fractions to trading in decimals. This change, I understand, has reduced the spread captured by floor traders from public investors and has made the stock tables easier to understand for ordinary investors.

I understand that if the exchanges did not mandate trading in minimum increments of one-eighth of a dollar, or 12.5 cents to the rest of us, large-volume stocks like IBM and Coca-Cola would trade in increments of 1 or 2 cents. This may not sound like a lot of money, but in the context of 500 million shares per day it adds up.

I understand that Commissioner Wallman, who is with us today, has estimated that retail investors get charged an extra $1.5 billion per year in making trades because of fractionalized spreads.

Large institutional investors are insulated from this practice because of their ability to negotiate spread on large-block trades. It is the little guy who is paying full freight.

I plan to seek information from both our witnesses today and from others on whether this would be an appropriate area for Congressional action.

Once again, it is a pleasure to welcome our friend, Chairman Levitt, and members of the Securities and Exchange Commission.

[The prepared statement of Hon. Michael Oxley follows:]

PREPARED STATEMENT OF HON. MIKE OXLEY, CHAIRMAN, SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS, COMMITTEE ON COMMERCE

It is with pleasure that I welcome Chairman Arthur Levitt, Commissioner Steve Wallman, Commissioner Isaac Hunt and Commissioner Norman Johnson to the Subcommittee to consider the reauthorization of the Securities and Exchange Commission. The SEC is charged with the supervision of our financial markets, the protection of investors and the promotion of efficiency, competition and capital formation. In carrying out this charge, the SEC helps to make the American public markets work more efficiently, and in so doing, promotes job creation by small business and economic growth for all Americans.

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I would like to commend my friend, Tom Manton, the Ranking Minority Member of this new Subcommittee and I look forward to working with him and all the members of the Committee to seek bipartisan solutions to some of the issues facing our markets today. I would also like to commend Chairman Tom Bliley, and thank him for his leadership on financial services issues. I commend John Dingell, the Ranking Minority Member of the full committee for his many years of activity in this area. Finally, I would like to commend Ed Markey, former Chairman of one half of this subcommittees jurisdiction, and look forward to his continued leadership on issues affecting our financial markets.

I am pleased to note the strong performance of our financial markets, a vibrant stock market that has raised trillions of dollars for American business, and the unparalleled access that Americans have to participation in these markets through mutual funds, 401 K plans and direct investment in stocks and bonds. It is the substantial freedom in which market participants conduct their affairs, that I believe contributes to dynamic innovation, and risk taking which are central to the capital formation process. I believe the SEC has contributed to this process by letting the market create new products unshackled by regulatory burden, while at the same time vigorously pursuing those who engage in fraud.

Under Chairman Levitt's leadership, the SEC worked cooperatively with the Committee, which on a bipartisan basis, passed the National Securities Markets Improvement Act, which was enacted into law last October. The Improvement Act made a number of important changes to the securities laws, including providing for exclusive federal registration of a wide range of securities offerings, lowering the cost of borrowing for broker dealers, and providing for cost benefit analysis of SEC rulemaking. I would like to thank Chairman Levitt for his assistance on this important legislation, and we look forward to constructive discussions with and oversight of the SEC as we seek to implement the Improvement Act's important changes.

I intend to introduce legislation to Reauthorize the Commission in these two fiscal years. A discussion draft of this legislation is before each of you. We will be working on a bipartisan basis to see that the important work of the Commission continues to receive adequate funding. In that respect, we will be building on the work that Chairman Bliley accomplished in the last Congress working with Hal Rodgers of the Appropriations Committee, Bill Archer of Ways and Means, and John Dingell and Ed Markey in providing a stable funding plan for the SEC that over the next ten years will reduce the surplus in fees collected by the agency above the cost of running the agency.

There are a number of issues that I think merit our attention as we consider the reauthorization of the SEC. The SEC has requested authorized funding levels of $320 million in fiscal year 1998 and $342.7 million in fiscal year 1999. We would like some additional background on the plans the Commission has for the agency in the next two years. In addition, pursuant to changes under the Improvement Act, the SEC is required to consider efficiency competition and capital formation in its rulemaking. This important new requirement is, I believe, a constructive way for an agency to conduct cost benefit analysis of its rules. We hope that this analysis will serve to improve SEC rules, lowering regulatory burden on businesses seeking to raise capital to create new jobs, and improving the general acceptance of SEC rules in the issuer community at large.

The Commission is working with the Financial Accounting Standards Board to develop new accounting treatment for certain derivative products. The United States is the world leader in over the counter derivative contracts. There are over $12 trillion in notional principal amount of these privately negotiated contracts issued by U.S. dealers. Preventing regulatory burdens that would diminish the utility of these contracts to business seeking to mitigate risk is an important goal. I want to stress to the Commission the importance of insuring that any accounting proposal be structured in such a way as to minimize disruption to these vitally important contracts.

Pursuant to both the Private Securities Litigation Reform Act and the National Securities Markets Improvement Act, we achieved, on a bipartisan basis, significant modernization of the laws governing our financial markets. In this Congress, I believe that some consideration to both the role and the rules of the Self Regulatory Organizations, like the New York Stock Exchange, the National Association of Securities Dealers and the American Stock Exchange would be beneficial. The SROs, as they are known, provide a useful service to the markets by allowing market participants to police themselves, which is efficient and saves the government money. In the course of this self regulation, we want to be sure that the Exchanges are not erecting rules that are designed to protect their members from competition or disadvantage public investors.

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Once again it is a pleasure to welcome Chairman Levitt and the Members of the Securities and Exchange Commission. I yield back the balance of my time.

Mr. OXLEY. I now turn to our ranking member, the gentleman from New York, Mr. Manton, for an opening statement.

Mr. MANTON. Thank you, Mr. Chairman.

I'm very pleased to be here this morning to participate in the reauthorization hearing for the Securities and Exchange Commission. As the newly appointed ranking member on this subcommittee, I'm very much looking forward to working with you, Mr. Chairman, in a cooperative and bipartisan manner over the course of the next few years.

I also want to welcome the distinguished chairman of the SEC, Arthur Levitt, and thank him for all of his hard work over the last 4 years. I have a great amount of respect for Chairman Levitt and the other commissioners who are also with us today and I look forward to working closely with the SEC during the 105th Congress.

As a representative from the great State of New York, home to the largest financial market in the world, I appreciate the vital role the SEC plays in maintaining the strength and integrity of our markets.

The importance of this industry to New York cannot be exaggerated. Not only do the exchanges and financial institutions provide both the city and State with enormous tax revenues, but they also provide jobs to thousands of New Yorkers. In fact, record profits on Wall Street last year resulted in more than $450 million in unanticipated tax revenue for the city of New York.

Securities markets in this country serve a vital role by raising necessary capital for new industries, creating jobs, funding resource and development, as well as generally supporting future growth of the Nation's economy.

Since its creation in 1934, the SEC has functioned as a law enforcement agency by policing fraud and abuse and providing essential services to both the business community and investors by ensuring that our financial markets are maintained in a fair and orderly fashion.

Over the last 15 years, the SEC has been faced with many new challenges due to huge increases in the volume of securities offered and traded, as well as technological developments that allow instant and inexpensive communication between the markets and its participants.

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While new technology offers great opportunity for investors, it also poses significant risk.

I applaud the chairman and the commissioners for keeping pace with this rapidly changing industry and for ensuring that, above all, individual investors are protected from fraudulent activity and are furnished with clear and trustworthy information.

Mr. Chairman, I hope that we are able to carry on the cooperative spirit that prevailed last year during the debate and with the passage of the National Securities Markets Improvement Act.

I would also like to thank my esteemed colleagues, Chairman Bliley and ranking democrat, Mr. Dingell, as well as former Chairman Jack Fields and Congressman Ed Markey for all of their diligence and work on that very important legislation.

I fully trust that we'll be able to follow their example when working on issues that come before this committee during the 105th Congress.

Again, thank you, Mr. Chairman, for holding this oversight hearing to address the funding needs of the SEC. I look forward to learning more about how the Commission plans to implement last year's act and to getting a progress report on a number of rules proposed or adopted since its enactment.

I yield back the balance of my time.

Mr. OXLEY. The Chair now recognizes the gentleman from Virginia, the chairman of the full Commerce Committee.

Mr. BLILEY. I thank you, Mr. Chairman.

I would certainly like to commend you for holding this hearing so that we may consider the important work of the Securities and Exchange Commission. I would also like to commend Tom Manton, the ranking minority member of the subcommittee. I look forward to working with both of you on the issues affecting our financial markets.

I would also like to commend my friend, John Dingell, ranking minority member of the full committee, and Ed Markey, who was the ranking member for Finance in the last Congress, for their help as we, on a bipartisan basis, passed a bill that became the National Securities Markets Improvement Act.

It is with pleasure that I welcome Chairman Levitt, Commissioner Steve Wallman, Commissioner Isaac Hunt, and Commissioner Norman Johnson to the subcommittee to consider the reauthorization of the Securities and Exchange Commission.

I would like to commend Chairman Levitt for his service at the SEC and for the professionalism and lack of partisanship that he has brought to the Commission.

The SEC has an important role in suppression of fraud and the supervision of our financial markets. Through this work the SEC promotes the protection of investors and efficiency, competition, and capital formation in our markets.

One of the charges that I have in this Congress from the leadership is to conduct oversight of the agencies under our jurisdiction to see that they are carrying out the laws that the Congress has passed. I am working to make this a constructive process rather than one of finger-pointing.

We are going to ask questions of many agencies on a variety of topics. One of the recurring themes in this inquiry will be whether

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agencies are considering the cost of regulation in the context of rulemaking they undertake. So-called "cost/benefit analysis" may be resisted at first as something that is difficult or gets in the way. It will, however, in the long run, improve both the quality and, I might add, the acceptability of agency rules.

More importantly, cost/benefit analysis is now required by law. We expect agencies will comply with this requirement.

The National Securities Markets Improvement Act contains a provision requiring the consideration of efficiency, competition, and capital formation whenever the SEC engages in a rulemaking.

The SEC supported this provision in its testimony to us, and I personally intervened to get this provision into the statute in place of one that the SEC did not support.

I have written to the commissioners to ask what steps have been taken to implement this important new requirement.

We are also anxious to work with the Commission to see that it has adequate funding for its needs, including support for the Office of Chief Economist that is charged with assisting the mission with analysis of these rules.

I intend to work with Chairman Oxley, Tom Manton, and John Dingell to enact reauthorization legislation that provides for the needs of the agency. This will be in continuation of the work that I did last year with Hal Rogers and Bill Archer, and then with the administration, to provide a long-term funding mechanism for the SEC that will, in time, reduce the reliance of the agency on fee revenue and fund the agency by means of an appropriation.

I understand that the SEC is seeking authorization of $320 million for fiscal year 1998, which is essentially flat from the $318 million approved by the committee in the last Congress.

I understand that the SEC is requesting an increase to $342.7 million in 1999.

I look forward to the testimony so that we can be educated on the needs of the Commission for this initial authorization.

Once again, I welcome the commissioners of the SEC to the committee and look forward to their testimony.

I yield back the balance of my time.

Mr. Chairman, I'm going to have to go to another hearing shortly, but I hope to be back.

Mr. OXLEY. I thank the chairman.

[The prepared statement of Hon. Tom Bliley follows:]

PREPARED STATEMENT OF HON. TOM BLILEY, CHAIRMAN, COMMITTEE ON COMMERCE

I would like to commend my friend Chairman Mike Oxley for holding this hearing so that we may consider the important work of the Securities and Exchange Commission. I would also like to commend Tom Manton, the Ranking Minority Member of the Subcommittee. I am looking forward to working with both of you on issues affecting our financial markets. I would also like to commend my friend John Dingell, Ranking Minority Member of the Full Committee, and Ed Markey who was the Ranking Minority Member for finance in the last Congress for their help in the last Congress as we, on a bipartisan basis, passed the bill that became the National Securities Markets Improvement Act.

It is with pleasure that I welcome Chairman Arthur Levitt, Commissioner Steve Wallman, Commissioner Isaac Hunt and Commissioner Norman Johnson to the Subcommittee to consider the reauthorization of the Securities and Exchange Commission.

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One of the charges that I have in this Congress from the leadership is to conduct oversight of the Agencies under our jurisdiction to see that they are carrying out the laws that the Congress has passed. I am working to make this a constructive process, rather than one of finger pointing. We are going to ask questions of many agencies on a variety of topics.

One of the recurring themes in this inquiry will be whether agencies are considering the cost of regulation in the context of the rulemaking they undertake. So-called cost benefit analysis may be resisted at first as something that is difficult, or gets in the way. It will, however, in the long run, improve both the quality and acceptability of Agency rules. More importantly, cost benefit analysis is now required by law: we expect agencies will comply with this requirement.

The National Securities Market Improvement Act contains a provision requiring the consideration of efficiency, competition and capital formation whenever the SEC engages in rulemaking. The SEC supported this provision in its testimony to us, and I personally intervened to get this provision into the statute in place of one that the SEC did not support. I have written to the Commissioners to ask what steps have been taken to implement this important new requirement. We are also anxious to work with the Commission to see that it has adequate funding for its needs, including support for the Office of the Chief Economist that is charged with assisting the Commission with analysis of these rules.

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I understand that the SEC is seeking an authorization of $320 million for fiscal year 1998, which is essentially flat from the $318 million approved by the Committee in the last Congress. I understand that the SEC is requesting an increase to $342.7 million in 1999. I am looking forward to the testimony so that we can be educated on the needs of the Commission for this additional authorization.

Once again I welcome the Commissioners of the SEC to the Committee and look forward to their testimony.

I yield back the balance of my time.

Mr. OXLEY. I now recognize the gentleman from Maryland, Mr. Wynn.

Mr. WYNN. Thank you, Mr. Chairman, but I would defer an opening statement at this time. I would like to reserve the right to submit at a later time.

Mr. OXLEY. Without objection.

The gentleman from Ohio, Mr. Gillmor.

Mr. GILLMOR. Thank you, Mr. Chairman.

First, I want to commend Chairman Levitt and the Commission for the presentation that they did at the subcommittee a week ago, which I thought was excellent.

I also want to thank the chairman for working with us on a couple of issues over the course of the last few weeks.

I want to take this opportunity to commend you on your effort to help prospective investors better understand their investment options.

The proposal to require mutual fund companies to write the prospectus in plain English will help inform Americans not only of new opportunities, but also increased risks and confusion that the markets may afford them.

As Chairman Levitt stated in recent weeks, for the first time in history Americans now have more of their money invested in mutual funds than they do in the deposits of commercial banks.

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The biggest holders are not banks and not insurance companies or big business, but hardworking Americans who have discovered opportunities for investment in the securities market.

Our goal—all of us, I think—is providing those investors with the protection and the confidence they need to realize their financial goals.

There are a number of issues that I've brought up privately with the chairman that hopefully we can explore somewhat in the question period: the area of mutual fund fees, not only the high level of mutual fund fees, but also the idea of the 12b-1 fee and the way that it's used, and also the issue of charitable contributions by public corporations.

I welcome you here and thank you, Mr. Chairman.

Mr. OXLEY. I thank the gentleman.

The gentleman from Massachusetts?

Mr. MARKEY. Thank you, Mr. Chairman, very much.

I'm very impressed with the new management team brought in to run this very important committee.

I want to thank the Securities and Exchange Commission for appearing before us here today, especially Chairman Levitt.

Under our Federal securities laws, the SEC is responsible for assuring that investors receive full disclosure of material information regarding America's public corporations, accurate accounting statements regarding the financial condition of these companies, fair markets in which their shares may trade, and appropriate supervision of the investment professionals who manage the public's money or provide them with investment advice.

The SEC also acts as our Nation's securities cop on the beat, enforcing the Nation's laws against con artists and fraudsters who seek to defraud the investing public out of their money.

Each of these missions is essential to the continued success of the capital formation process which provides entrepreneurs with the productive capital needed to create jobs, provide new products and services, and introduce new technological innovations.

But what the SEC does is equally important to the lives of ordinary Americans whose hopes for the future—hopes of being able to send a child to college, buy a new home, or retire in dignity—are increasingly tied to the stability, the integrity, and the success of the financial markets.

Today the traditional company plan indexed to inflation has been replaced by new defined contribution plans that ask workers to contribute to their pensions and make decisions about how their money should be invested.

At the same time, America is being transformed from a Nation of savers to a Nation of investors. Presently there is more money invested in mutual funds than deposited in savings and checking accounts in our Nation's banks.

In search of the higher yields offered in our financial markets, millions of Americans have poured their savings into mutual funds, turned to financial planners for investment advice, or invested directly in stocks and bonds. But with the promise of higher yields also comes the pitfalls of increased risk.

To protect investors against risk, we rely on the full disclosure system administered by the SEC to help the public make informed

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decisions about which companies to invest their money. At the same time, we rely on the SEC enforcement program to guard investors against the risk of fraud and deception.

In the face of the unprecedented influx of capital into our markets and the increasing participation of small investors in these markets, the SEC's budget has remained essentially flat for the last 2 years.

As we will hear today, the Commission will need increased resources in the future if it is to keep pace with the challenges posed by the market's rapid growth and the emergence of new trading strategies and technologies and the new investment of much of America's wealth into this marketplace.

While experts warn today of the dangers of a certain irrational exuberance creeping into the markets, we must recognize that Congress ultimately cannot legislate bull markets or pass laws banning bear markets. We can, however, assure that there will be fair markets.

This morning we will be examining what resources the SEC needs over the next 2 years to carry out its vital mission of investor protection and maintenance of fair and orderly markets.

While we will undoubtedly be hearing much about the costs and burdens of securities regulation, we must never, ever lose sight of the enormous benefits: high levels of investor confidence in the fairness and integrity of our markets, deterrence of fraud and misconduct, and more-educated and-informed investors who can avoid making bad investment decisions in the first place.

I particularly want to commend you, Chairman Levitt, for the leadership that you have shown in strengthening our full disclosure system through better municipal securities market disclosure, new mutual fund disclosure requirements, adoption of plain English prospectuses, approval of a short profile prospectus, and new derivatives disclosure requirements.

I look forward to hearing your testimony today on these and other subjects.

I want to commend you, Mr. Chairman, and you, Mr. Manton, for calling this hearing today.

Thank you.

Mr. OXLEY. I thank the gentleman from Massachusetts and thank him for his past leadership as a chairman and ranking member of this subcommittee and for all of the work that he's done, and we look forward to working with him as a continuing member of the subcommittee on these important issues.

The gentlelady from Wyoming, Mrs. Cubin.

Mrs. CUBIN. I don't have any remarks at this time, Mr. Chairman. Thank you.

Mr. OXLEY. I thank the gentlelady.

The gentleman from Florida, Mr. Deutsch.

Mr. DEUTSCH. Thank you, Mr. Chairman.

One of the nice things about so many opening statements is it gives us a chance to read the witnesses' testimony.

Let me thank the——

Mr. OXLEY. You mean you weren't listening to the opening statements of your colleagues?

Mr. DEUTSCH. I read copies of them.

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Mr. MARKEY. Does anyone have a copy of the chairman's statement right now? I need one right now for the next 5 minutes.

Mr. DEUTSCH. But I, too, want to compliment the Commission and particularly the chairman. I think he has made an incredible effort in terms of taking very seriously the job of consumer education.

The series of meetings that he has done around the country is something I know has been time consuming but I think well served.

I again want to thank him particularly for the meeting he did in Fort Lauderdale, which the response that I've heard has been incredibly positive.

We are living through a gilded age in America. Just some of the numbers that you have in the testimony are just absolutely incredible—63 million American households are now invested in mutual funds, 90 percent of the money saved in the 1990's has gone into mutual funds.

It is a world that didn't exist 10 years ago, and the challenges faced by that world I think you are meeting, but I think they remain incredible challenges.

I think within even the concept of living within your existing fiscal restraints—I hope you're not being too conservative in asking us for resources to meet those new challenges because, in fact, that's exactly what they are.

And the fact that we do have the safest, freest, best capital markets in the world is not just a theme that has created the locomotive of the American economy, but I think very seriously, when we look at free flow of capital, which our founding fathers over 200 years ago talked about, free flow capital is truly the backbone of freedom, itself.

I think your work truly is God's work when you're working as the Securities and Exchange Commission, so I look forward to your testimony.

Thank you.

Mr. OXLEY. I thank the gentleman.

The gentleman from California, Mr. Bilbray.

Mr. BILBRAY. Thank you, Mr. Chairman. I want to thank you for conducting this hearing, and I'd like to thank the chairman and the commissioners for being here this morning.

My main concern this morning is on an issue that has arisen regarding the implementation of the National Securities Market Act of 1996 and an issue of great concern by the State of California and its economy. The issue involves the continued availability of the exemption from registration as a "covered security" established under section 3(a)10 of the Securities Act of 1933.

California has had a long and successful history utilizing this exemption to avoid the cost associated with duplicating State and Federal filings.

The trouble is that after the enactment of the act recently the question has arisen about the continuing availability of the 3(a)10 exemption.

I believe the 3(a)10 exemption should continue to remain available to issuers as an exemption under the Securities Act of 1933.

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California is one of the few States that has offered this hearing process on a voluntary basis to companies seeking a lower-cost alternative to Federal securities registration.

California's fairness hearing process has proven to be efficient and effective to fulfill the requirements, or at least the intended requirements of the 1933 act.

Frankly, my concern, Mr. Chairman—and I would ask that the chairman address this—is that in November there was specifically a request made to you or your staff to clarify this issue for the State of California. This was the beginning of November. As far as I have been informed, there has not been any response. I look forward to hearing an explanation for the silence on the SEC's part regarding the interpretation of the National Securities Markets Act and how it affects or didn't affect the 3(a)10 exemption.

I am also troubled with the fact that the SEC has not answered this letter, and I would ask that we try to communicate.

California is a small, intimate group of 30 million people, and I would just ask that we try to clarify that.

I must apologize. I have a hearing to go to, too, but I will be looking for this information. It's something that we'd love to get addressed. I don't think anyone meant to pass the new legislation in a manner that would cause more disruption in effective review and protection of the consumers, and I think that we all agree that historically this exemption has worked so well in California that no one intended to basically create another hurdle where we had already eliminated the hurdle and found more effective ways.

So once again, Mr. Chairman, I thank you for holding this hearing and I look forward to the testimony of the witnesses, specifically to the item that I just identified.

I yield back the remainder.

Mr. OXLEY. I thank the gentleman.

The gentlelady from Colorado?

Ms. DEGETTE. Thank you, Mr. Chairman.

Welcome, Chairman Levitt and everyone else.

I am very pleased to be here at my first meeting of this subcommittee, and I'm very pleased with the emphasis that the SEC is having on investor protection.

I was impressed last week, when I visited the SEC, to see that this is a new emphasis given the recent bull market, particularly with the unprecedented growth of mutual funds. The things that impressed me were the investor education programs you've undertaken, including educational programs, web sites, the national town meetings, some of which have been attended by thousands of people; and also the aggressive enforcement of securities laws.

One thing I'm particularly concerned about is that we undertake a continuing aggressive program, both of civil enforcement and of criminal prosecution of securities violators.

With that, being the last one to make an opening statement, I think everything else has been said. I'd like to hear from the panel here today, so I'll yield back my time.

Mr. OXLEY. I thank the gentlelady.

The gentleman from Washington State, Mr. White.

Mr. WHITE. Mr. Chairman, I have no comments either. Thank you very much.

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Mr. OXLEY. Let me indicate Congressman Rick Lazio from New York cannot attend today's hearing. He's chairing his own subcommittee hearing on housing, community opportunity, and will be submitting a statement for the record.

All statements for the record will be appropriate and unanimous consent granted therefore.

We now turn to our distinguished panel.

Chairman Levitt, it's good to have you back before the committee. This is the first time you've been to the newly constituted subcommittee, and, as other members have indicated, your leadership in this area, particularly in regard to investors' rights and so forth, have been extraordinary. We appreciate your leadership, and we welcome you to the subcommittee.

STATEMENT OF HON. ARTHUR LEVITT, CHAIRMAN; ACCOMPANIED BY: HON. STEVEN M.H. WALLMAN, COMMISSIONER; HON. ISAAC HUNT, COMMISSIONER; AND HON. NORMAN JOHNSON, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Mr. LEVITT. Thank you very much, Chairman Oxley and members of the subcommittee.

I appreciate the opportunity to speak on behalf of my fellow commissioners regarding the SEC's authorization for fiscal years 1998 and 1999.

I'd like to introduce my colleagues with me here today. On the far right is senior Commissioner Steven Wallman. Next to me is Norman Johnson. And in the center is Commissioner Isaac Hunt.

We are seeking authorization for appropriations of $320 million in fiscal year 1998 and $342.7 million in 1999.

These requests represent the Commission's best estimate of the resources we will need to maintain effective regulation of U.S. securities markets.

All of you know that our markets are the deepest and fairest and most liquid in the world and that they have experienced enormous growth during the longest and most vigorous bull market in history.

The past year the Dow average has broken 5-, 6-, and then 7,000 points. New York Stock Exchange and NASDAQ market have both seen the stock market trading volume at all-new highs. And assets in mutual funds, as was mentioned before, have reached record levels of $3.5 trillion, a figure that vastly exceeds the $2.5 trillion that Americans have deposited in commercial banks.

Compared even with the year just before, 1996 set some extraordinary records. Total dollar volume traded on the exchanges and the NASDAQ stock market surpassed 1995 volume by over 31 percent. Registered public offerings broke the trillion dollar mark, rising 36 percent over the preceding year. And initial public offerings rose to $50 billion, up from $30 billion in 1995, a 67 percent increase.

The mounting participation of small investors in the United States' securities markets has fueled a great deal of this growth.

Today, one in three American households owns an interest in a mutual fund. The number of first-time investors grows day by day

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and will accelerate if Congress acts to privatize a portion of the Social Security program.

Whether up or down, such broad-based markets absolutely don't happen without investor confidence in the integrity of the system.

I think that after 64 years of successful regulation we sometimes take that for granted. For a reality check, consider the extreme opposite end of the spectrum.

As we sit here this morning, rioters are in the streets of Albania, and the army there has been given orders to shoot to kill in order to quell the crisis. Why? At bottom it's because investors were not protected from pyramid schemes, one of the simplest and most common financial frauds around.

In the United States, however, thanks to the wisdom of Congress, investors are confident that if a pyramid scheme wipes out someone's savings, the Government is going to wipe out that pyramid scheme. Period. It's that confidence that's the cornerstone of our markets.

The Commission has fulfilled its mission to protect investors and to maintain fair and orderly markets with modest staffing and limited resources.

I came to the Commission after a lifetime in the private sector and, though I'm certainly keenly mindful of the differences, I've tried to run the Commission like I'd run a business. One of the key principles that I've applied is that, especially when resources are limited, you've got to improve productivity. That's why, when I first came to the Commission, I closed one regional office and rationalized the reporting structure of those that remained.

To take another example of how we've improved productivity, we've cut in half the amount of time it takes for us to process rule filings from self-regulating organizations.

Perhaps the best illustration of all of that is that for 3 years in a row now the SEC has kept pace with what may be the most explosive growth ever seen by our markets while its budget has remained essentially flat.

The growth in our markets shows no signs of slowing.

My colleagues and I have concluded that we can continue to fulfill our statutory mandate in 1998 on a budget similar to that contained in the 1997 authorization bill. By 1999, however, the anticipated size of the securities markets, as well as the challenges posed by, among other things, evolving technology, increasing globalization of finance, the continuing creation of new financial instruments, and the growing number of inexperienced investors will likely strain the Commission's resources.

We anticipate that by 1999 we will require additional funding flexibility to meet not only these challenges, but also the mandatory pay and contractual cost increases outlined in the President's budget.

Let me give you a brief idea of the kinds of things we were able to achieve in 1996 with your budgetary support.

In the past year, in addition to fulfilling our traditional mandate of investor protection, the Commission emphasized efforts to reduce the cost for companies participating in the securities markets. As you may recall, we asked Philip Howard, an outspoken advocate of

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regulatory common sense, to help us clear away some of the regulatory underbrush that had built up over decades.

With his advice and guidance, the Commission Task Force on Disclosure Simplification recommended the elimination or modification of fully a quarter of the rules and half of the forms the SEC imposes on public companies.

We've already done away with 44 rules and 4 forms, and more will follow in the year ahead. The reduced cost for companies should encourage the process of capital formation.

Also last year we revised the order handling rules to ensure that all markets are fair and open to investors and that all prices are based upon competition. We upgraded the SEC Worldwide Web site, which now has an average of 2.5 million visits per week and downloads approximately 24 million pages of financial information per week, placing it among the Federal web sites with the highest activity, at no cost to the investing public.

We asked those who write prospectuses to use a new language, the English language, and to help them do so we released a "Plain English Writing Guide." We proposed rules to simplify mutual fund prospectuses and to allow funds to distribute profiles.

We eased the limitations on the sale and resale of restricted stock and the sale of unregistered stock to reduce the cost of capital formation, and we also continued our vigorous enforcement of the Federal securities laws, including work with the FBI and the Justice Department, to bring criminal charges against those who prey upon American investors.

In presenting today's authorization request, the Commission has been mindful that Government resources are really strained. I'd argue, however, that Congress receives an extraordinary return from the funds that it allocates to the Commission.

Our entire budget for fiscal year 1997 is $305 million. To place that in perspective, $322 million will be spent on the sport fish restoration program this year.

Now, I'm an avid sport fisherman, Congressman Deutsch, and I know that the sport fishing industry provides many Americans with jobs and many more Americans with something exciting to do on their day off. I support it, and I think that the securities markets are also worthy of support, especially at a time when so much important work lies ahead.

Among the challenges we face over the next 2 years will be: The growing number of small investors who invest their retirement savings in mutual funds through retirement plans—I would say the bulk of those investors are relatively unsophisticated, who have not experienced a down market in nearly 14 years; the special concerns raised by the increasing use of derivatives and other complex financial products; facilitating and encouraging greater use of communications technology by companies, brokers, dealers, and investors; completing our mutual fund disclosure initiatives, including fund profiles and more clearly written and-presented mutual fund prospectuses; considering alternatives to the current model of capital formation, including the idea of registering companies as opposed to offerings of securities, an idea set forth by Senior Commissioner Wallman; redesigning the EDGAR electronic filing system; securing more foreign listings and signing more cooperative agree-

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ments with foreign regulators; conducting an aggressive effort to police internet fraud; shining a spotlight on the use of soft dollar payments through examinations of investment advisors, institutional investors, and broker dealers; completing our reevaluation of the net capital rule so desperately required by the securities industry; granting qualified immunity to firms for disclosures made on the U-5 forms.

We also will reach another milestone in the municipal bond market as dealers put in place procedures that will result in the reporting of retail price and trade information by the end of this year.

The Commission would like to take this opportunity to thank our oversight committees and staff for their hard work in forging a consensus to solve the Commission's funding problems. As a result of Congress' bipartisan efforts, a more stable funding structure will allow us to plan better for our future needs.

The markets of our country are so sensitive and so important we can afford nothing less than the kind of spirit which has permeated this committee as long as I can recall, and that spirit is to work together in a nonpartisan mode for the benefit of America's investors.

We hope that the subcommittee will adopt our authorization request so that the Commission may continue to promote capital formation and protect investors in the vitally important U.S. markets. Thank you.

[The prepared statement of Hon. Arthur Levitt follows:]

PREPARED STATEMENT OF HON. ARTHUR LEVITT, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Chairman Oxley and Members of the Subcommittee: The Securities and Exchange Commission (SEC or Commission) appreciates this opportunity to testify regarding the Commission's authorization for fiscal years 1998 and 1999.

The Commission seeks authorization for appropriations of $320 million in fiscal year 1998 and $342.7 million in fiscal year 1999. These requests represent the Commission's best estimate of the minimum resources we will need in each year to maintain effective regulation of the U.S. securities markets.

This level of appropriation should permit the Commission in 1998 and 1999 to address foreseeable issues that will arise from the securities markets' current rate of exceptionally rapid growth. These estimates also reflect the Commission's efforts to support Congressional interest in balancing the federal budget.

The U.S. securities markets are widely regarded as the deepest, most liquid, and fairest markets in the world. These markets experienced considerable growth throughout the 1980s, and since 1991 have continued this growth with the longest and most vigorous bull market in history, driven, in part, by investor confidence in their integrity. In the past 12 months alone, the U.S. securities markets have experienced exponential growth:

- the Dow Jones Industrial Average has broken the 5,000, 6,000 and 7,000 point levels;
- the New York Stock Exchange and the Nasdaq Stock Market have each seen stock trading volume hit all-time highs; and
- assets in mutual funds have reached record levels of $3.5 trillion—a figure that surpasses the more than $2.6 trillion Americans have on deposit at commercial banks—and continue to grow monthly.

This growth builds on 1996, a year when:

- total dollar volume traded on the exchanges and the Nasdaq Stock Market exceeded 1995 volume by 31 percent;
- registered public offerings grew to $1.045 trillion, an increase of 36 percent from 1995 offerings; and
- initial public offerings rose to $50 billion, up from $30 billion in 1995, a 67 percent increase.

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The ever increasing participation of small investors in the U.S. securities markets fuels some of this growth. Many of these investors now choose to invest their funds for retirement in the securities markets, often through mutual funds. The number of first-time small investors participating in the U.S. securities markets grows daily. Small investor participation will accelerate even more rapidly if Congress acts on proposals to privatize a portion of the Social Security program.

The Commission always has fulfilled its mission to protect investors and maintain fair and orderly markets with modest staff and limited resources. A review of SEC appropriations for 1990-1996 shows that our resources increased at a fraction of the rate of increase of participants and assets invested in the securities markets.[1] At the same time, the Commission has addressed many significant issues and events, such as educating new investors who are pouring money into the securities markets, regulating continuing innovations in derivative products and activities, and the financial collapse of Orange County.

The incredible growth in the U.S. securities markets described above shows no sign of slowing. We have concluded that we can continue to fulfill our statutory mandate in 1998 at a level close to that contained in the 1997 authorization bill. By 1999, however, the anticipated size of the securities markets, as well as the challenges posed by, among other things, evolving uses of technology in the securities markets, increased globalization of the securities markets, and the continuing creation of new financial instruments, likely will strain the Commission's ability to do our job. Therefore, we believe that by 1999 we will require additional funding flexibility to ensure that we can respond to these new issues as well as to meet mandatory cost increases outlined in the President's budget.

In the past year, the Commission has undertaken a number of initiatives focused on protecting investors and promoting the integrity of the securities markets. Some of these initiatives will reduce regulatory burdens in light of the growth and development of the capital markets and the evolving technology available to market participants. These initiatives should reduce the costs of participating in the securities markets for investors and other market participants. Reduced costs, in turn, should enhance the markets' depth and liquidity by encouraging more capital formation and investment. Other initiatives address specifically the need to protect market participants, large and small. Some of our most significant accomplishments in recent years include:

- revising the order handling rules to assure markets that are fair and open to investors and that are based on competition;
- upgrading the SEC World Wide Web site, which now has an average of 2.5 million "hits" per week (which translates to approximately 250,000 users per day) and downloads an average of approximately 24 million pages of financial information per week—making it one of the most active federal Web sites;
- publishing two interpretive releases to facilitate electronic commerce and to maintain at the frontier the Commission's positions regarding electronic media under the federal securities laws;
- proposing requirements that issuers use plain English in prospectuses and releasing a plain English writing guide for issuers;
- proposing rules to simplify mutual fund prospectuses for investors and investment companies and rules to allow a mutual fund to provide a "Fund Profile" summarizing concisely, in a standardized form, key information about the fund;
- easing the limitations on sales and resale of restricted stock and sales of unregistered stock to reduce the cost of capital formation; and
- continuing vigorous enforcement of the federal securities laws, including work with the FBI and the Justice Department to bring criminal charges against those who prey upon American investors.

The remainder of this testimony describes these accomplishments in greater detail. It also outlines additional issues the Commission will need to address in the next two years to ensure that the U.S. securities markets remain the safest for investors and the deepest, most liquid, and fairest markets in the world.

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[1] For example, since 1995, the Commission has had flat staffing. During the same period, the total trading volume on the New York and American Stock Exchanges and the Nasdaq Stock Market increased from 207 billion to 264 billion shares (a 27.5 percent increase); the value of public offerings increased from $768 billion to $1.045 trillion (a 36 percent increase); the value of initial public offerings increased from $30 billion to $50 billion (a 67 percent increase); and investment company assets under management increased from $3.062 trillion to $3.794 trillion (a 24 percent increase).

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Reducing Regulatory Burdens

The Commission understands the current government-wide budgetary constraints. We regulate the nation's securities markets with a modest staff and limited resources, operating in partnership with the private sector rather than through pervasive regulation. The Commission staff is small compared to the scope of the agency's mission and the size of the nation's markets.[2] As a general principle, the SEC supports market-driven regulation—under which the Commission takes responsibility for core regulatory areas, while much of the direct, day-to-day regulation of securities market participants is done by firms themselves and by private membership organizations (self-regulatory organizations or SROs), under SEC oversight. In this context, the Commission has worked with the securities industry to provide cost-effective regulation in partnership with the private sector. For example:

- The Derivatives Policy Group (DPG), established by the six broker-dealers with the largest derivatives affiliates, developed a framework for voluntary oversight of the over-the-counter derivatives activities of unregulated affiliates of securities firms. The DPG recommended improved management controls, enhanced quantitative reporting to the SEC and the CFTC, and guidelines designed to foster integrity and responsible conduct with respect to derivatives end-users. The DPG members provide information to the Commission, which we integrate into our financial responsibility and risk assessment programs.
- A task force of SRO and broker-dealer representatives, working with the SEC, developed continuing education recommendations for the broker-dealer community. The SROs adopted uniform continuing education requirements, approved by the SEC, which, for the first time, require each securities firm to prepare training programs addressing the characteristics, risks, suitability, and sales practice considerations of the securities products the firm offers.

The Commission continuously reevaluates regulatory burdens to determine whether the effectiveness of SEC regulations justifies their burden. A number of Commission programs recently were the subject of such reevaluations, the results of which are described below:

Easing capital formation. The Commission regularly seeks to simplify the regulatory structure for registration and reporting by public companies. Over the past two years, two panels have worked to advance these goals. The Task Force on Disclosure Simplification examined every rule related to corporation finance and, in March 1996, recommended eliminating or modifying a quarter of the rules and half of the forms. To date, the Commission has eliminated 44 rules and 4 forms, and plans to eliminate more. The Task Force also proposed a number of other initiatives (which the Commission is beginning to consider) to further increase access to capital markets. These include:

- adding greater flexibility to the offering process to assist issuers with timing and pricing;
- liberalizing the rules restricting cross-border tender offers; and
- expanding the small business exemption for selling securities to employees.

The Advisory Committee on Capital Formation and Regulatory Processes had a broader mandate to reexamine the entire regulatory process for securities offerings. In July 1996, the Committee proposed a fundamental shift in our regulatory scheme from registering transactions to registering companies. The goals of a company registration system would be to streamline capital formation while enhancing investor protection. The Advisory Committee believes the system would eliminate unnecessary complexities in our regulatory system and encourage more registered offerings with earlier and better access to information. The Commission has requested comments on the company registration model as well as on other ways to modernize regulation of the offering process.

The Commission recognizes that small business is the lifeblood of the American economy. Thus, the Commission has adopted a number of initiatives designed to facilitate small business access to capital and to ease regulatory burdens on small business. These include:

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[2] The SEC has only 2,726 employees across the country—to oversee dynamic markets that have grown to be worth more than $10 trillion. The bank regulators, on the other hand, operate under a direct, comprehensive regulatory system for banking activities and (notwithstanding recent personnel cutbacks) maintain staffs that are, in the aggregate, much larger than the SEC's staff. The FDIC, for example, expected to have staff of approximately 8,700 by the end of 1996 to carry out the agency's function as insurer and backup regulator of approximately 11,400 insured banks and thrifts. *See* Barbara A. Rehm, *FDIC Cuts Budget by 8%; Sets Thrift Insurance Rates,* Am. Banker, Dec. 12, 1996, at 2. The Commission does not wish to suggest that one scheme of regulation is better than the other rather that each model has different strengths, tailored to the requirements of the relevant industry.

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- creating a new exemption from registration requirements for limited offerings of up to $5 million that are exempt from qualification under California law;
- doubling the asset threshold that subjects companies to registration under the Securities Exchange Act of 1934 (Exchange Act) from $5 million to $10 million, with the effect of reducing the number of small businesses subject to Exchange Act reporting requirements;
- allowing limited resales of restricted stock (often held by investors in all businesses) after one year and unrestricted sales after two years;
- appointing a special ombudsman to assist small businesses and to serve as the liaison and agency spokesman for small business concerns; and
- upgrading the Commission's Web site to include a page addressing issues of specific interest to small businesses.

Market regulation. The Commission recognizes that regulation often imposes costs on securities markets. Therefore, the Commission is vigilant in trying to reduce those costs whenever it is consistent with the protection of investors.

Recent amendments to the net capital rule demonstrate the Commission's efforts to make regulation more efficient and economic. The Commission recently approved the use of option pricing models to calculate required net capital for both listed options and the related positions that hedge those options. The Commission adopted this amendment after determining that use of the model would more accurately reflect the risk inherent in a firm's options positions and in many cases would reduce a firm's capital charges. The Commission is considering additional rational approaches to the net capital rule, such as using value-at-risk models, in an effort to further amend the rule so that it more effectively recognizes, and can be adjusted to take into consideration, each firm's financial exposures.

Another regulatory initiative under consideration would create a new class of limited purpose broker-dealers to facilitate derivatives transactions. Under current regulations, securities firms conduct their derivatives activities in separate affiliates, many of which are outside of the United States and therefore beyond SEC jurisdiction, depending on the nature of the derivatives activity. A new class of "limited purpose" broker-dealers would be subject to modified capital, margin, and other regulatory requirements tailored to the derivatives business, which is intended to encourage a U.S. securities firm to conduct all its counterparty activities in various derivatives products in a single U.S. affiliate. By consolidating and repatriating the firms' derivatives positions in these "limited purpose" broker-dealers, the Commission anticipates significantly improving oversight of the derivatives market.

In response to the National Securities Markets Improvement Act of 1996 (NSMIA), the Commission has rededicated itself to considering how its rules affect competition, efficiency, and capital formation as part of its public interest determination. Accordingly, the Commission intends to focus increased attention on these issues when it considers rulemaking initiatives. In addition, the Commission measures the benefits of proposed rules against possible anti-competitive effects, as required by the Exchange Act. However, we believe more could be done in this area. Over the next several years, the Commission intends to increase the number of economists on its staff in order to conduct even more comprehensive economic analyses of the impact of Commission rulemaking on financial markets and their participants.

Examinations. In 1995, the Commission created the Office of Compliance Inspections and Examinations (OCIE) to improve the Commission's efficiency and effectiveness in examining regulated entities. That year, OCIE, the SROs and state regulators developed a framework for better examination coordination under a Memorandum of Understanding (MOU).[3] As a result, about 85 percent of the broker-dealers who requested coordinated SRO examinations in 1996 received them, and we hope to reach close to 100 percent this year. OCIE, the SROs, and the state regulators also have initiated a series of summits at which they work together to improve examination coordination. We hope to build on this beginning and coordinate efforts even more effectively in the future.

Other steps the Commission has taken to make its examination program more efficient and to address the increasing disparity between the size of the securities industry and available resources include:

- an increasingly "risk-based" examination program focusing on registrants whose activities or practices increase customer risk or the likelihood of compliance problems and areas within specific firms that pose the greatest risks; and

[3] Many of the principles in the MOU were codified in NSMIA.

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- examinations focused on specific sectors of the securities industry, such as transfer agents, or on specific industry practices such as sales practices among broker-dealers and financial planning activities of investment advisers.

Next month, as required under NSMIA, the states will become the primary regulators for small investment advisers. As a result, the Commission will refocus examination resources on the investment advisers with the greatest impact on the national markets—those that manage 98 percent of the assets under management in the United States. Pursuant to NSMIA, our obligations regarding small advisers will continue, however. We will provide training, technical assistance, and other support to state regulators, and will conduct joint examinations, classroom training, joint sweep examinations, and other similar operations.

To ensure adequate investor protection, our examination program must keep pace with the phenomenal growth in the securities industry. For example, additional resources are necessary for the Commission to increase the frequency of inspections of transfer agents and clearing agents, some of which handle securities issued to millions of investors, and to review the internal controls of large securities firms. Similarly, we need to devote more resources to monitoring supervision in firms with rapidly increasing networks of broker-dealer branch offices, many of which are one-person branches operated by independent contractors. Finally, funding is needed to develop advanced technology systems for tracking examinations, selecting registrants for review, developing computerized examination and research tools, and coordinating with other national and state regulatory authorities and organizations.

Investor Protection

The Commission's foremost mission is the protection of investors. The Commission pursues this mission through vigorous law enforcement, regulatory initiatives, and programs to inform and educate investors.

Law enforcement. Over the past few years the Commission has made a substantial effort to address market-wide problems in the securities industry and widespread violations of the securities laws. For example, the Commission recently participated in a sting operation with the FBI and the National Association of Securities Dealers (NASD) that resulted in criminal charges against 46 stock promoters, company officials, and current or former brokers for illegal kickbacks to brokers for sales of over-the-counter and Nasdaq stocks. The Commission also brought 22 administrative proceedings against 29 of the individuals criminally charged.

In January 1996, the Commission brought enforcement actions against Orange County, the Orange County Flood Control District, two county officials, and the county board of supervisors in connection with the fraudulent offer and sale of over $2.1 billion in municipal securities. In November 1996, the Commission also brought an enforcement action against CS First Boston Corporation and two of its investment bankers in connection with their role in underwriting one of the fraudulent bond offerings. The Commission continues its enforcement proceedings brought in the wake of Orange County's financial collapse in 1994.

In addition, last summer the Commission concluded an 18-month investigation of the Nasdaq Stock Market, in which the Commission found that market makers coordinated their quotes so that investors paid too much and received too little when they bought and sold stock on the Nasdaq Stock Market. The Commission also found that the NASD failed to ensure the accuracy and fairness of the quotation and transaction information, failed to apply certain rules to its members, and selectively enforced rules against others. In August 1996, the Commission announced a far-reaching settlement with the NASD, in which the NASD committed to spend $100 million over five years to improve its surveillance, examination, and enforcement of the handling of customer orders. The NASD also agreed to make important structural changes to ensure that it represents adequately the interests of investors and responds effectively to indications of anti-competitive practices or other wrongdoing.

In addition to the significant resources devoted to these major cases, the Commission maintains its vigorous enforcement program against individuals and firms that violate the securities laws. Over the past two years, the Commission brought over 900 enforcement actions against over 2,000 defendants and respondents. These cases involved domestic and international insider trading, Ponzi schemes, misleading disclosure, kickbacks or conflicts of interest relating to municipal securities offerings, broker-dealer sales practice abuses, and unregistered securities offerings over the Internet. For example:

- *In the Matter of Bennett Funding Group, Inc.* Bennett Funding allegedly raised over $570 million through the sale of purported equipment leases; the proceeds of sale were diverted to the company's former chief financial officer (CFO) and

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persons connected with him or the other defendants; the former CFO consented to a preliminary injunction and asset freeze in these pending proceedings.

- *In the Matter of Kent Ahrens*. The Commission initiated an injunctive action and an administrative proceeding against the senior trader at a registered investment adviser who engaged in unauthorized trading that resulted in losses of $137 million to the Common Fund, which manages endowments for 1,400 U.S. colleges and universities.
- *In the Matter of Systems of Excellence*. The Commission obtained a temporary restraining order and asset freeze and suspended the trading of Systems of Excellence, a public company purportedly in the business of video teleconferencing, to stop an on-going manipulation involving false press releases and fraudulent Internet postings. The Commission's asset freeze preserved millions of dollars for defrauded investors. Charles D. Huttoe, the former Chairman and CEO of Systems of Excellence, subsequently pled guilty to criminal charges of securities fraud and money laundering.

As we look ahead, we know that the Commission must dedicate additional resources to policing fraud on the Internet. The ever-increasing level of securities activities occurring over the Internet will force the Commission to expand its activities in order to keep up.

Broker sales practices. The Commission continues its campaign to improve broker sales practices. In 1996, the Commission, NASD, New York Stock Exchange, and state regulators joined in an examination sweep focused on these practices. The sweep identified a number of problems in broker sales practices, including excessive trading, unauthorized trading, improper registration of representatives, cold-calling violations and deficiencies. Furthermore, one-third of the examinations conducted in the sweep found varying degrees of supervisory problems. As a result of these findings, state and federal regulators and the SROs initiated disciplinary actions and, with the industry, increased their emphasis on supervisory procedures and obligations.

In response to another industry practice, the Commission is currently examining the soft dollar arrangements of mutual funds, investment advisers, and brokerage firms. The Commission also has announced plans to examine possible sales abuses by insurance companies selling variable annuities.

Order handling rules. In the context of the enforcement action against the NASD, the Commission identified a need for rules to further assure that markets are open and fair to investors, and are based on competition, not coordination. The order handling rules, which went into effect in January, are intended to let competition foster increased fairness, efficiency and best execution:

- by requiring that dealer quotes reflect investor limit orders;
- by requiring public display of "hidden" dealer interests; and
- by requiring public display of trading activity in significant proprietary systems and requiring that the national best bid and offer reflect that trading activity.

The rules permit investors to compete directly with dealers and with other investors on the basis of price, which we believe will allow the market more fully to reflect investor interest. In the year ahead, the Commission will work with the securities firms and the NASD to implement these rules to ensure that these market reforms benefit investors.

Improvements in disclosure. Adequate and accurate disclosure of financial and other material information regarding issuers and securities is essential to investor protection. The Commission recently initiated and adopted several programs to improve disclosures. Last year, the Commission launched a pilot program that offers expedited review of required securities reports to companies that write their prospectuses in plain English. This program has drawn universal praise from its participants (which include major corporations such as GE Capital, Bell Atlantic, and ITT). This year, the Commission proposed rules to require the use of plain English in prospectuses and published a draft handbook to assist issuers in preparing reports in plain English. Last month, the Commission adopted new rules requiring companies to disclose specific information about their derivative activities and related market risks. These rules give investors tangible, quantifiable information about these instruments and their potential consequences for a company's financial position.

Mutual fund disclosures. The Commission also targeted investment company disclosures for improvement. Last week, the Commission proposed three new initiatives representing the most significant change to mutual fund disclosure the Commission has undertaken in the last 14 years.

- The Commission proposed to overhaul the prospectus requirements and registration form for mutual funds. The proposal focuses prospectus disclosure on essen-

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tial information about a particular fund that would assist an investor in reaching an investment decision, while minimizing disclosure about technical, legal, and operational matters that generally are applicable to all funds. In conjunction with the Commission's plain English initiative, described above, this proposal is designed to make fund prospectuses easier for investors to use and easier for funds to prepare.

- As the culmination of a two-year experiment, the Commission proposed to permit a fund to provide investors with a short (three to four page) disclosure document called a "profile." The profile would summarize key fund information (including investment strategies, risks, fees, and past performance) in a concise, standardized format that is easy to read and helps investors compare different funds.
- The Commission proposed a new rule that would require a fund's name to better reflect its investment strategy. The rule is intended to provide an investor greater assurance that a fund's investments will be consistent with its name.

Investor education. Investor protection requires investor education. The Commission emphasizes the importance of investor education through outreach programs that assist investors and small businesses to understand the capital markets and the securities industry. In addition to the plain English initiatives described above, recent Commission initiatives include:

- creating a toll-free telephone Investor Information Line;
- conducting town meetings across the country, in which the Commission answers questions and provides helpful advice to investors; and
- creating a series of easy-to-read brochures about choosing brokers or mutual funds.

Technology

Recent advances in communications technology have increased access to the securities markets for investors and businesses. Every advance brings new challenges in applying the securities laws. For example, the Internet already has changed the face of brokerage and investment management, through on-line trading and other innovations, and may also redefine disclosure and what constitutes an exchange. In the past two years, we have published interpretive releases, rules, and no-action letters to provide guidance on the use of electronic media under the federal securities laws. The Commission is excited about the greater access to capital markets that technology can bring, but we are concerned that the Commission will not have adequate funds in the coming years to meet the corresponding challenges that technological innovations will pose. We are racing to keep up with new developments while maintaining our existing technology. As noted above, the SEC's home page has become one of the most popular government sites on the World Wide Web, and we evaluate constantly how to facilitate access to the extensive information available there. In addition, our EDGAR database of corporate information, while on the cutting edge of technology 10 years ago, will begin a major overhaul by the end of this year.

Promoting the International Competitiveness of U.S. Markets

The depth and integrity of the U.S. securities markets have made our markets preeminent in the world and, as a result, have attracted increasing numbers of foreign issuers and investors. This continuing internationalization benefits U.S. markets and investors alike. It promotes the leading position of the U.S. markets and gives U.S. investors a broader array of investment choices within the strong disclosure and investor protection framework of the U.S. markets. The Commission has sought to promote internationalization of the U.S. markets, while safeguarding their transparency and fairness. Initiatives include:

- streamlining registration, reporting, and reconciliation requirements for foreign companies;
- permitting, in cross-border offerings, the use of certain international accounting standards in portions of financial statements filed with the Commission; and
- streamlining financial statement disclosure requirements for both foreign and domestic issuers with respect to acquired foreign businesses.

In addition, the Commission, both directly and indirectly, through the International Organization of Securities Commissions (IOSCO), continues to participate in the efforts of the International Accounting Standards Committee (IASC) to develop a core set of high-quality, comprehensive, international accounting standards. The development of a single set of standards that can be used in securities markets around the world would allow companies more readily to cross borders to raise capital in markets that offer favorable financing conditions. The IASC has set a goal of completing these standards by March 1998. The Commission will report to Con-

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gress on progress in the development of international standards in October 1997, as required by NSMIA.

Due in part to the Commission's internationalization efforts, foreign issuers increasingly turn to the U.S. markets to raise capital. Foreign issuer offerings of securities in U.S. markets have almost quintupled, from about $30 billion in 1990 to approximately $144 billion in 1996. Since January 1, 1996, over 160 foreign companies from 35 countries have entered our reporting system, including companies from Chile, China, France, Indonesia, Italy, Russia, and the United Kingdom. As of December 31, 1996, 843 foreign reporting companies representing 47 countries were registered with the Commission.

With increased international trading comes a need for better cooperation and communication regarding the regulatory and enforcement issues that may arise between the U.S. and foreign regulators. The Commission has entered into 29 arrangements with foreign authorities for cooperation. By providing for cooperation among regulatory agencies, these arrangements facilitate enforcement investigations into cross-border securities transactions.[4] Similarly, in the regulatory area, the Commission works with its foreign counterparts to address concerns relating to global systemic risk. On a multilateral basis, the Commission has taken a leading role in international efforts to assure high quality market standards and coordinate enforcement activities through organizations such as IOSCO and the Council of Securities Regulators of the Americas.

Conclusion

The Commission plays a vital role in protecting U.S. securities markets from fraud, manipulation and other practices that continually threaten to undermine the integrity of our markets. To maintain current operations, respond to market growth, and develop initiatives for emerging issues, particularly in the areas of technology and globalization, the Commission needs adequate funding. Therefore, the Commission urges adoption of this authorization request, which provides the framework for accomplishing the Commission's critical responsibilities.

In presenting today's authorization request, the Commission has been mindful that government resources are strained. The Commission recognizes, however, that important work lies ahead of us. Among the challenges we will face over the next two years are:

- issues posed by the increasing number of small investors who invest their retirement savings in mutual funds through retirement plans;
- responses to the special concerns raised by the increasing use of derivatives and other complex financial products; and
- maintaining vigilant oversight of markets as those markets grow increasingly complex and volatile.

The Commission would like to take this opportunity to thank this Committee and its staff for their hard work in forging a consensus to solve the Commission's funding problems. As a result of Congress' bipartisan efforts, NSMIA will move us to a more stable funding structure and allow us to plan better for our future needs.

In order to take on new challenges, and to continue the Commission's excellent record of effective investor protection, law enforcement, and market oversight, the Commission will need funding at least at the levels requested today. We therefore urge the Subcommittee to adopt our authorization request in order to allow the SEC to promote capital formation and maintain effective oversight of the vitally important U.S. markets.

Mr. OXLEY. Thank you, Mr. Chairman.

I want to ask you the obligatory question on reauthorization before we get into some other areas, and that is, obviously, the essential need for the Commission for an additional $22 million for the fiscal year 1999. I think your testimony clearly pointed that out. Perhaps you might want to get into a little more detail for the committee in setting out those goals.

Mr. LEVITT. Right. It's difficult to be absolutely precise because so much depends upon conditions and changing markets.

[4] In 1996, the Commission made 230 requests for enforcement assistance to foreign governments and received 340 requests for assistance from foreign authorities, pursuant to these cooperation arrangements. The success of the Commission's international enforcement program has been recognized; our system has served as the model for other domestic legislation and for securities regulators around the world.

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We, for the past 3 years, have tried to do more with less, and no commission is capable of eliminating all fraud and corruption. We try to be targeted in terms of those areas that represent the greatest risk to the system and to America's investors.

However, as we look to the future, the increase of approximately $22 million is broken down in the following way: $6.1 million for additional staff, principally for our prevention and suppression of fraud program, where we have asked for 25 new positions; our inspection and examination activities, 20 positions; and our investment management program, 15 positions. An additional 24 positions are allocated among market technology, disclosure, and cost benefit activities.

In terms of technology, to enable our computer system to maintain its currency, we've asked for $5 million.

The rest of the increases, approximately $11 million, are based upon mandatory increases consistent with the administration budget.

Mr. OXLEY. Thank you.

Let me turn to Commissioner Wallman.

I've read with some interest your article that appeared in The San Francisco Chronicle dated November 13, 1996, and I ask unanimous consent to include this and other articles on decimal pricing in the hearing record.

[The referenced articles follow:]

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FORUM

How Decimal Trading Helps Investors

By Steven M.H. Wallman

OUR SECURITIES MARKETS are the most efficient and fairest in the world. It is surprising then that every year we tolerate billions of dollars in lost revenue to investors as a result of trading stocks in fractions — those eighths and quarters — rather than dollars and cents.

What is even more curious is that the traditional fractional trading system does not result from the operation of the free market; rather it is imposed by rules and practices of the stock exchanges and the NASD that preclude their members from competing by trading in decimals. Hardly what you would expect from a system as open and competitive as ours.

Starting today, The Chronicle takes a bold step toward making the stock market more understandable by publishing quotations in decimals — plain dollars and cents. A survey of Chronicle readers showed an overwhelming preference for decimals. Somewhere in there is a lesson for Wall Street.

This clearly is progress. But we need to eliminate anti-competitive and artificial restrictions on stock prices — like trading in fractions. With some variations across markets, the majority of our stocks still trade as they did over 200 years ago with fractional increments of one eighth of a dollar, or 12½ cents. If this increment were reduced by as little as a penny per share on each transaction, savings to investors could be over *$1 billion each year every year.* If the average spread was reduced to a nickel, which happened for many stocks in Canada when the Toronto Stock Exchange (the only other major market in the world that was trading in fractions) moved to decimals earlier this year, the savings could approach $5 billion to $10 billion every year. So while the amount that might be saved by any particular investor with decimals may or may not be significant, in the aggregate we are talking about a whole lot of pennies!

How would investors save? For every stock traded on an exchange or the Nasdaq system, there is a spread. Narrow the spread, and investors can buy for a little less or sell for a little more.

So — now that the rest of the world has moved to decimals — why haven't we? One argument raised by the industry is that allowing trading in finer increments — like nickels instead of eighths — will shrink the profitability of securities firms, reducing their willingness to buy and sell with investors on a regular basis. Another fear is that trading in decimals, especially in pennies, could disrupt "trading priority" in our markets — which generally process orders in the priority of the highest order to buy and the lowest order to sell — because priority could be obtained by bettering another order by just a penny. Other arguments against decimals center on the costs of converting computer systems at the exchanges from fractions to decimals, and the view that "If the system ain't broke, don't fix it."

But let's look at these arguments. A shift to decimals does not necessarily mean a decline in the profitability of securities firms. While trading profits on some stocks may narrow, possibly others may remain unchanged or even increase; admittedly, however, spreads on average will narrow — that's the savings to investors. More likely though, reducing the cost to investors of trading stocks may actually increase the *volume* of trading with an overall increase in firm profitability. Whether it was a direct cause or not, that's what happened after fixed price commissions were abolished and the discount brokerage industry was born. In addition, firms can always charge commissions if necessary to earn a profit and, unlike spreads, commissions are disclosed to investors. Finally, if we were to experience a decline in the number of securities firms as a result of decimal trading, it would be due to actual *market forces* — competition among firms — which happens every day in other industries. We typically view competition as providing *advantages* to investors and the market more generally.

On the second point, improving on a prior order by as little as a penny is still a better price. But if that really is a concern, we could move to an increment of a nickel instead. That is still real money for investors.

While costs of computer conversions may not be trivial, they would be one-time costs for the exchanges (and, in fact, many of the systems in place today are already set to trade in decimals). These costs pale next to the recurring savings from a finer trading increment, and they pale next to the conversion costs that the rest of the world has to incur every day in transforming decimals to fractions and back to decimals for accounting, record keeping, reporting, and analysis of stock trades.

Finally the system clearly "ain't broke." But is that any reason not to make it better? For at least a century our markets have been the best, and our task has been to continue to make them better. Who would want to wait until we fall behind and then try to catch up? As the securities markets become more global the U.S. — the last bastion of fractionalized trading — eventually we'll have to shift to decimals if we are to remain the world's premier market. And investors are losing money now without even knowing it. So, like the change in stock tables because the public wanted it, we can change the markets if the public demands it. Why wait?

Steven M.H. Wallman is a commissioner of the U.S. Securities and Exchange Commission. He has called on the securities industry to convert to a decimalized trading system as soon as practicable but no later than Jan. 1, 1999. The views expressed in the article are those of Wallman and do not necessarily represent the views of the Securities and Exchange Commission.

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Studies Back Using Cents In Stock Deals

C21 YOUR MONEY MATTERS 11/21/96

By Vanessa O'Connell
Staff Reporter of The Wall Street Journal

Small investors would save billions each year if Wall Street stopped trading stocks in quirky fractions and started using plain-old cents.

That's the implication of three new studies of the Canadian markets after they abandoned fraction-pricing and adopted decimals earlier this year.

The research is drawing attention in Washington and on Wall Street, because it provides fresh evidence supporting a switch to decimal pricing in the U.S.

Some powerful players have been pounding the table for decimals, including a commissioner of the Securities and Exchange Commission. But the securities industry has long resisted, citing an uncertain impact on profits and the markets overall.

The studies shed new light on the issue by measuring the outcome in Canada since major markets there switched to decimals in April. All three studies focused on the Toronto Stock Exchange, where stocks trading for $5 or more are now priced in five-cent ticks, rather than increments of one-eighth, and shares selling for $3 to $5 are priced to the nearest penny, rather than the closest nickel.

Decimal pricing "turned out to be a big win for investors" in Canada, says Jeffrey P. Ricker, a San Francisco investment strategist and consultant who studied changes in activity of all Toronto Stock Exchange listed stocks from Jan. 2 to June 28, 1996. Canadian investors are saving about 1.3 Candian cents per share traded (U.S. one cent), or a total

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A Case for Common Cents

- *Spreads narrow, slashing trading costs for small investors*
- *Measuring gains and losses is easier*
- *Market makers keep profits*
- *Public orders increase, boosting Wall Street's commission revenue*
- *U.S. markets brought in line with global markets*

Continued From Page C1

C$214 million a year, assuming an average daily trading volume of 50 million shares, Mr. Ricker figures.

Canada is home to the only major exchanges in the world that have ever made a switch from fractions to decimals. U.S. stocks have traded in eighths since colonial days, when Spanish coins were sliced into eight pieces, known as "bits," and used as currency. A stock trading at 7 5/8 today is selling for seven dollars and 62.5 cents.

Trading in eighths is enormously profitable for Wall Street, because the spread between a stock's "bid and asked" prices will typically always be at least 1/8 of a dollar, or 12.5 cents. Stocks are sold at the "ask" price and bought at the higher "bid price." The difference between these two prices is known as the "spread" and represents the middleman's profit.

When Canada's exchanges moved to decimal pricing, spreads shrank. For instance, the average spread for stocks trading above $5 fell by an average of 18.9%, according to Jeffrey M. Bacidore, a lecturer at Indiana University in Bloomington. He examined stocks trading on the Toronto Stock Exchange, but not in U.S. markets, from Feb. 2 through June 12.

Smaller spreads might cause the profits earned by middlemen to shrivel, some have speculated. That could prompt them to abandon trading stocks altogether, making it more difficult for all investors to quickly buy or sell shares, the thinking goes.

But in Canada, such fears turned out to be overblown. Daniel G. Weaver, an assistant professor of finance at Milwaukee's Marquette University, scrutinized the profits earned by market makers and other members of the Toronto exchange for every trade. Not only were the professional middlemen able to continue making money — thanks mainly to shrewdly timed purchases and sales, or market timing — but they also saw commission revenue grow as the number of public orders jumped.

"Allegations [by the securities industry] that profits will be reduced with decimal pricing are unfounded," Dr. Weaver concludes.

Wall Street isn't convinced yet, however. "Communism sounded good too, until it became real," says E.E. "Buzzy" Geduld, president of Herzog Heine Geduld, the largest wholesale market maker.

Edward Kwalwasser, a group executive vice president in charge of regulation at the New York Stock Exchange, says the Big Board is "looking at all of the new data so we can make an informed decision."

SEC member Stephen H. Wallman shocked many in the securities industry this fall when he called for a move to decimal pricing before 1999. If a conversion saved buyers and sellers just a penny per trade — a conservative assumption — investors would have pocketed $1.5 billion last year alone, he said in an interview. "Investors need to understand that they are losing billions of dollars a year with fraction pricing," he added.

Commissioner Wallman's outspoken views have "certainly moved decimalization to the front burner," says John Tognino, president of the Security Traders Association, whose membership includes brokers and specialists.

Small investors haven't rallied behind decimal pricing, mainly because they're unaware of cost savings arising from narrower spreads. But most would support a switch for convenience alone. In a survey this summer of nearly 1,600 readers, the San Francisco Chronicle found that 62% would prefer to see stock prices shown in dollars and cents. The newspaper began accommodating them this month by asking its Chicago stock-quote provider to convert all fractions to decimals, rounding up any prices with half-pennies.

Mr. OXLEY. I'd like for you to explain to the committee the basics of how stock trading in fractions currently works. Are the increments set by exchange rule?

Mr. WALLMAN. Yes, Mr. Chairman, they are.

The current requirements for trading in fractions, which have been longstanding in our securities markets and date back really to the beginning of the securities markets, are currently enforced, if you will, through exchange regulations and through a policy of the National Association of Securities Dealers, the NASDAQ system. So it is basically a systems matter and it is a regulatory and policy matter at the exchanges and at the NASDAQ system.

Mr. OXLEY. How would changing to decimalization help investors?

Mr. WALLMAN. There have been a number of views as to the cost savings that individual investors will receive. They come primarily from a narrowing of the spread.

Right now when you want to buy or sell a stock you buy it at a price and sell it at a price, and the difference between the bid and the ask is the spread.

That said, if the minimum increment on our exchanges is an eighth, 12.5 cents, as you mentioned, if that spread can be narrowed to a nickel, for example, or something less or something more, but something less than 12.5 cents, then those savings can accrue to the person who is engaged in the trading.

The estimate of about $1 to $1.5 billion dollars is actually per penny saved. So if you were able to narrow the spread by 2 or 3 cents or 4 or 5 cents, you can save, obviously, multiple billions of dollars.

The Toronto Stock Exchange recently did switch over. Now our's are the only markets left in the world that are still trading—the only major market left in the world that are still trading—in fractions.

The Toronto Stock Exchange recently changed from fractions to decimals, and they found that the average spread was reduced by almost a third.

So if that's anything like what would occur in our markets, your talking about really multiple billions of dollars of savings for investors.

Mr. OXLEY. What kind of reaction—how long has that been in place in Canada in the Toronto Exchange?

Mr. WALLMAN. A number of months at this point. There have been preliminary studies which have shown what the spread has contracted to. It went from about 16 cents on average to about 11 cents on average, and there have been studies which have shown, in some cases, that volume has increased somewhat. Other studies have had different views with regard to volume.

I think the studies are still somewhat preliminary, but clearly, with regard to the narrowing of the spread, the clear benefit, in particular for the smaller investor, there seems to be no doubt. It's relatively unequivocal. There is a great benefit for smaller investors.

Mr. OXLEY. We continue to see trading worldwide with all of the technology and the like that literally traders can participate in

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markets all over the world 24 hours a day, and yet you say our markets are the only ones that have not become decimalized?

Mr. WALLMAN. The only major ones.

Mr. OXLEY. What is your opinion in terms of our competitiveness with other markets if we continue to keep the current system?

Mr. WALLMAN. Long-term it will have to have adverse effects. Long-term, if you have increasing determinations to, for example, as one of our exchanges has announced, determination to try to list foreign country stocks in the home currency, and all those are trading in decimals, to have a fractional trading system here means arbitrage opportunities between the markets. It will become more reasonable for someone to look at our market if they think the spread is higher and be able to trade in arbitrage fashion in a home market where the spread may be narrower.

The only way that that exchange, therefore, will really be able to compete long-term is by moving to decimals and moving basically to the same increment that is traded abroad.

It would be a real shame, I think, to have a more competitive system and a narrower spread for foreign stocks traded in this country than for our own domestic company stocks.

It's really a competitive issue long-term for the exchanges.

Moreover, there is a benefit to investors, just in terms of the ease with which stock tables, as you mentioned, can be read.

The San Francisco Chronicle switched from fractional stock table presentation to decimals because readers found it much easier. Anyone engaged in market trading would find it much easier to use systems that are based on decimals.

And, of course, we're paying a very large amount in terms of analytical programs and computers at this point, all of which otherwise are in decimals, where people are, instead of being able to use off-the-shelf software, having to get customized software that is able to take fractions as opposed to decimals.

Mr. OXLEY. Thank you.

My time has expired. I would obviously want to return to that on a second round, but with that I recognize the gentleman from New York.

Mr. MANTON. Thank you, Mr. Chairman.

I'm going to direct my questions to Mr. Levitt, but anyone may jump in if it is in their particular area of interest.

I first want to thank Chairman Levitt for having a breakfast meeting for the committee over at the SEC where we got an insider's look at what has been happening. I think it was a very important exchange.

I'm going to repeat a question that I asked at that meeting.

In your own testimony you've indicated that this is one of the longest bull markets, if not the longest, in the history of trading, a 14-year bull market. In fact, a lot of the participants in the current market were never in a down market. They probably don't know what that means.

We all know that the market goes up and at times goes down. There is no question about that.

Do we have a plan for any precipitous drop in this current market, now that we've crossed and recrossed and probably will cross

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again the rubicon of 7,000 on the Dow? Do we have the fire engines ready, or is that something we shouldn't talk about?

Mr. LEVITT. I think that, in terms of the major factors that come into play at a time of market volatility, we're better able to handle that volatility today than any time before in history. I'm talking about such things as communications between the various participants. Today, with one phone call, I can be in touch with every major market center in the country and a number of others throughout the world.

In terms of the capacity of the various market centers to handle surges of volume, we are much better off today than ever before, and the market planning of the various market centers I think is pretty much on target. They're able to handle, on a strategic basis, whatever surges might occur.

In terms of rules and regulations, circuit breakers, for instance, have been implemented since the 1987 market break.

Does that in any way insure us against a market event? I know you recognize, as I do, that it absolutely does not. What it suggests, however, is that we're better prepared to handle market events today than we ever were before.

I also would suggest that no two market events are ever precisely alike, so preparing for another 1987 I think is inadequate to the demands of a market that can be very perverse in terms of the kinds of problems that it can present.

But I think more work has to do done in terms of international cooperation because our markets are more globalized today than ever before, and that's an area that I think requires additional attention.

Mr. MANTON. The so-called "Year 2000 computer problem," perhaps you'd want to comment on that, what's been happening.

Mr. LEVITT. I think that the industry is taking appropriate steps to anticipate those problems. We're monitoring that closely. Our inspection program is geared toward evaluating that. I think some of the smaller firms have more work to do and we are encouraging that.

I think that the way the industry handled the move from T-plus-five to T-plus three, which represented a vast change both technologically and culturally, I think speaks well for the ability of this industry to handle a technological transition such as presented by the year 2000.

Mr. OXLEY. The gentleman's time has expired.

The gentleman from Ohio, Mr. Gillmor.

The Chair would note that there is a vote on the floor, a 15-minute vote followed by a 5-minute vote. I think we can dispose of the questions from the gentleman from Ohio within 5 minutes, and then we'll take a recess for the vote.

The gentleman from Ohio.

Mr. GILLMOR. Thank you, Mr. Chairman.

I had some discussions with Chairman Levitt recently over the issue of charitable contributions by corporations.

By way of background, let me say there's maybe a philosophical question here as to whose money the corporation's money is. Is it basically management's or is it the shareholders'? I think it's the shareholders'.

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In that respect, in terms of the contributions made by shareholders, I introduced last year two bills which I have reintroduced, one of which was co-sponsored by Chairman Oxley and ranking member Manton, and I'd like you to comment on these two proposals.

One would provide that, with certain exceptions that would be necessary, that the shareholders of a corporation could basically direct to which charities the money that would be allocable to their shares would go.

There is, as I understand it, a successful program of that nature which is done by Warren Buffett at Berkshire Hathaway.

The other would be a proposal to require disclosure by public companies of the amounts that they give to specific charities.

I'd like your comments on those two.

Mr. LEVITT. I think the notion of having shareholders' input into the process of corporate giving is useful. As to exactly how to do it, I'm not certain. I think that would take some study.

But I think that I agree with you that it is the shareholders' money, and I think that I have seen abuses of the power that is implied by giving vast sums of money to various causes. I believe by getting shareholder input you tend to balance what could be an abuse of that power by corporate management.

With respect to the disclosure of the specific objects of corporate giving, I have some reservations about that only because, by giving up those names, companies would subject themselves to a battery of requests from a broad array of millions of philanthropies out there. That might tend to discourage corporate giving in total, and I'd be concerned about that. So I think that will require some additional thought and study.

Mr. GILLMOR. Thank you, Mr. Chairman.

Let me ask you, these are introduced in the form of mandates, but they're really to get the discussion going.

Would you be averse to the language in the authorization calling for a study of those two issues?

Mr. LEVITT. I favor a study of those issues. I have learned, after nearly 4 years dealing with the Congress, that anything that is attached to something that is the lifeline for the Commission represents a lurking danger. So if I could avoid any attachment, I probably would say so.

Because of my affection for you and what you're trying to do, I'm reluctant to offer an impediment, but I do want to suggest that caveat.

Mr. GILLMOR. We'll try not to lurk.

Mr. LEVITT. Okay.

Mr. GILLMOR. Thank you very much.

Mr. OXLEY. I thank the gentleman.

The committee will stand in recess for 15 minutes.

[Brief recess.]

Mr. OXLEY. The Chair would note this should be the last vote, so we'll have the full attention of everybody, hopefully.

I've always thought that perhaps the best hearing would be on a day when the House is really not in session, where we could discuss the issues without having to run back and forth to the floor. But it occurred to me that if that occurred we would have no mem-

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bers, and that wouldn't be very effective, either. So we just deal with reality the way it is.

I now recognize the gentleman from Washington State, Mr. White.

Mr. WHITE. I thank the chairman. I really appreciate the virtue of being prompt in returning from the vote, because otherwise I think I'd be waiting a long time to ask these questions.

The first question I'd address to any member of the Commission, particularly Mr. Levitt. How has your experience been with the legislation that we passed last year? I felt that that was a big step in the right direction. I know we worked with the Commission pretty closely in developing that legislation. And I'd just like to know how things seem to be going so far.

Mr. LEVITT. It's probably early to tell, but I would say that the expectations of opponents and proponents of the litigation reform bill have not been realized—the worst expectations. I think the bill was a moderate bill and I think we've had—I cannot say that we've had any adverse experiences as a result of that bill.

I think that there is some indication that the way suits are filed these days is somewhat better than before. The rush to the courthouse steps seems to have diminished somewhat. But, aside from that, I think it's probably premature.

Perhaps my colleagues might have something to add to that.

Mr. WALLMAN. The only other observations I might make are that there are some studies that have come out at this point with some views on the experience, that there seems to be some migration into State courts and an increase in parallel Federal/State proceedings, which you might expect.

And on the side of having additional forward-looking statements, the hoped-for benefit of having more of them made is not quite as well realized as people might have otherwise hoped for or expected, and there are a number of different reasons that people have suggested for that.

But time I think will tell on all of this.

My own personal view is that probably the issue of trying to reconcile longer-term the question of the Federal/State relationship with regard to litigation is one that is going to be a continual matter until it is more finally settled, but that the Litigation Reform Act began that step with rationalizing the Federal provisions. Now I think it's the Federal/State relationship that will take some work.

Mr. HUNT. The other Federal/State relationship that is going to take some work is the new regulatory scheme with respect to investment advisors and the cutoff point between the Federal regulation and the State regulation, and we are working very hard with the representatives of the States to try to rationalize that system and see that there's no confusion about who is regulated by the Federal regulators and who is regulated by the State regulators.

Mr. WHITE. How is that relationship going? Are the States—are you reaching some agreements? Is it going to be harder than you thought?

Mr. HUNT. We're working with the States. I think we will be able to reach consensus. I think the organization that represents State regulators is very interested that we get a rational system out of this new federalism to work for both them and us.

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Mr. LEVITT. Mr. White, I may have misunderstood your——

Mr. WHITE. That was going to be my next question, actually, but I appreciated hearing about the Litigation Reform Act also.

Mr. LEVITT. Right. Please forgive me.

Mr. WHITE. Not at all.

Mr. LEVITT. But as far as the Fields bill is concerned, I think it's working quite well. We're very comfortable with it. We have not yet used the very important exemptive authority that has been given to us. We undoubtedly will use it this year to try to modernize our offering process, which is terribly important. But I am very, very affirmative about the results of that bill.

Mr. WHITE. And we don't have a whole lot of water under the bridge, I know, in that particular bill. When do you think we'll be able to really get a realistic view of how it is actually working? Or do you think we know now?

Mr. LEVITT. I think we can say now that it's working now. I would expect that as months go by we will say it's working better. I think the bill is doing pretty much what it was intended to do.

Mr. WHITE. Good. You made some comments earlier about making sure that our disclosure to shareholders is done in as plain English as possible, and I wonder if you could just give me a few milestones as to how that process is going.

I know when we were over for breakfast the other day we saw some examples of some new statements that had been issued under your guidelines. Are there other projects that you have underway to expand this, or——

Mr. LEVITT. Yes. I think it is a continuing process.

In the first place, we reached the state that we were in as a result of the Commission driving for more and more disclosure. It created over-disclosure, if that's possible—"bloated disclosure" is a better word for that.

The lawyers on both sides, both the Commission lawyers and filers' lawyers, wrote language that was absolutely unintelligible.

So I think the very fact that we are beginning to focus on this by calling for companies on a voluntary basis to use plain English is important.

Going forward, we will make it plain to companies that we will recognize those in very specific ways that use plain English, and we will hold accountable those companies that don't until they do. I think more and more companies will use plain English.

With respect to the investment company area, we have now given investment companies the right to use the profile prospectus, which will give them an opportunity—on a competitive basis, hopefully—to submit the clearest, most succinct, most comprehensible kinds of documents. And I think competition is going to drive them in a direction for disclosure that may not otherwise have occurred.

So it's an emphasis that we are going to continue. We're going to speak about it at every opportunity. It's a major thrust of this Commission, and I cannot emphasize sufficiently the importance we attach to it.

Mr. WHITE. Great. Thank you very much.

Mr. JOHNSON. May I? This is a very challenging project, and it is a milestone, and it's going to be very challenging for the bar to ask a group of people who have, for decades, worked at developing

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what they term "liability documents," rather than "disclosure documents," because the primary intent in drafting these documents, from the standpoint of careful lawyers over the years, has been to provide something that would protect their clients if there was later litigation.

Now, to have to write a plain English instrument, which provides the information that the investor needs, they're going to have to change all that.

Mr. WHITE. I think that's right. It's kind of linked with what we talked about earlier in terms of the litigation reform bill.

Mr. JOHNSON. And it's time we took that step.

Mr. OXLEY. The gentleman's time has expired.

Mr. WHITE. Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman from Massachusetts.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

I'd like to begin by examining a recent incident that has occurred in Massachusetts which raises a number of disturbing public policy concerns.

Centennial Technologies, a Billerica, Massachusetts, manufacturer of computer cards, was the most successful new high-technology stock traded on the New York Stock Exchange in 1996, with shares soaring in value by nearly 450 percent, rising to trade at $55 per share.

The company reported skyrocketing sales, had acquired several smaller high-tech firms, and was reported to be negotiating a lucrative deal with AT&T.

Then the bubble burst.

Following rumors of inflated earnings, suspicious options trade, Centennial abruptly fired the company's founder and CEO, Emmanuel Penez.

Several days later Mr. Penez was arrested on a wide array of charges, including insider trading, manufacturing false disclosure statements, and falsifying information regarding his academic credentials and background.

Press accounts now indicate that Mr. Penez inflated the company's revenues by booking phony sales of empty boxes of PC cards to companies owned or controlled by Centennial.

As questions had begun to arise about Centennial's financial performance, Mr. Penez reportedly bought thousands of options contracts, betting that the company's price would fall.

Today Mr. Penez is in jail for his activities, being pursued by the Securities and Exchange Commission. Centennial has been de-listed from the New York Stock Exchange and its stock is virtually worthless. But there are thousands of investors all across Massachusetts and all across this country who put their money into this company who have lost everything.

Now, the question that is being raised in Boston—I think it's a good question for the whole country—as a result of these events are the logical questions. And it was the same question that Judge Stanley Sporkin raised years ago in the Charlie Keating fraud case. Where were the auditors when this fraud was taking place over a series of years? What were the processes that were put in place in order to protect investors against this kind of activity? Where were

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the lawyers? Where were the financial professionals that put together the deals that put Centennial into the public markets?

My question to you, Mr. Chairman, is reflecting back on—in my opinion the worst provision in the private securities litigation bill was the section granting relief to the accounting profession from joint and several liability and replacing it with a weaker proportionate liability scheme.

What impact could this new liability scheme have on defrauded investors in a case of this kind?

Mr. LEVITT. Well, we are investigating the conduct of the auditor in this instance. I think that, under the Litigation Reform Act, the auditors would have proportionate liability rather than total liability for the wrongdoing of their clients, and I think the implications of that obviously are that investors would not be able to go after every partner in an accounting firm to make up that difference.

Mr. MARKEY. Can I say this? Admittedly it was, in fact, Coopers & Lybrand that identified the problem and brought it to the attention of the board of directors.

Mr. LEVITT. But if this was knowing violation, then proportionate liability would not be put into place, so that in that event the auditors would be totally liable, and that's what we're looking at now.

Mr. MARKEY. But are you concerned in the future, because, again, most of this activity occurred under the old laws. So my question to you is: are you concerned that in the future there is a reduction in the overall deterrent that should exist because accountants are not as liable as they had been in the past if, in fact, misconduct has not been identified?

Mr. LEVITT. I believe that there may be some very modest reduction in the total recovery that investors can obtain when the accountants have proportionate liability. I am satisfied, however, that the offset against that is the maintenance of an accounting profession that I think was in some jeopardy as a result of the proportion of liability that they sustained for so many years.

I recognize that there is, as I say, some limited possibility that investors will recover less. I think this is one of those instances where we have to balance what is in the best interest of the system, as a whole.

At this point, I don't recommend any change in that provision.

Mr. OXLEY. The gentleman's time has expired.

Mr. MARKEY. Thank you.

Mr. OXLEY. The Chair would begin a 5-minute second round.

Let me follow up on my line of questioning to you, Mr. Wallman, on the decimalization issue.

It has been argued that decimal pricing will adversely affect the profitability of securities firms. It has also been argued that it would be technologically difficult for the exchanges and the firms to convert their computer systems to decimal pricing.

Would you address both of those arguments?

Mr. WALLMAN. The argument with regard to profitability is similar to an argument which was made almost a generation ago in connection with the determination to unfix fixed commissions, where a number of commentators were concerned that there would be a great loss of profitability by a number of securities firms that had relied on fixed commissions, and that eliminating those would

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very adversely affect the profitability of those firms, perhaps even causing some of them to go out of business.

The result of unsticking the fixed commissions and allowing for competition was something that I think we all can look back on and say it was a great day for the securities markets.

There was an increase in volume that started shortly after that occurred; a whole new industry, discount brokerage, was born; and investors have done wonderfully well ever since.

The securities markets and the securities firms that were concerned about being adversely affected rationalized their behavior and, in many cases, have soared to record profits.

The assumption here is that, again, when you have a better system that's dictated more by competition instead of basically less vestige of fixed commissions, which is the mandated spread, you'll have again more competition dictating what the pricing will be in our markets, and you'll have those firms that are more efficient being able to compete better.

With regard to the technological problems, clearly those are ones that will have to be addressed. The ability to switch some of the systems overnight already exists. The ability to switch other of the systems on a longer-term basis obviously does exist, but it will take some time.

But delay is not the answer. As long as we continue to delay, the system problems simply never will be fixed.

And we actually have an interesting confluence of problems at the moment. We have the millennium problem, which you alluded to earlier, in terms of the year 2000 problem, and many of the systems are now being entered, in terms of their codes, to try to adjust to ensure that there is no year 2000 problem.

If there is a computer programming problem with regard to switching to decimals, this would be the appropriate time to fix it.

Mr. OXLEY. What is the experience so far with Canada, with Toronto Exchange going to decimalization, regarding both the profitability of the securities firms and the question of the millennium?

Mr. WALLMAN. The studies that I've seen so far, which are still preliminary, indicate that, as mentioned earlier, the profit, in terms of the spread, has gone down about a third, and that has been a cost savings to investors, and that's translated into the studies which indicate billions of dollars of savings in this country.

In terms of their technological problem, they had geared up for this. They had a date. They decided on a cross-over. They planned for it, and it worked quite smoothly.

Mr. OXLEY. How far in advance did they set that date? Do you remember?

Mr. WALLMAN. I don't know for sure. My understanding was it was probably about a year or so. But we could find that out for you if you like.

Mr. OXLEY. Well, aren't they going to have the same millennium problems that we are, though, in the overall big picture?

Mr. WALLMAN. I don't know whether or not they've already fixed that problem or not.

Mr. OXLEY. Okay.

Mr. WALLMAN. I know that they would otherwise have. All computers that have legacy-type systems in them have those problems,

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or at least need to be checked for them, and I assume that they probably checked for this, as well.

Mr. OXLEY. That would be helpful if we could find that out, or if you would, in fact, to forward that to the committee.

Mr. Wallman, the subcommittee has, in previous Congresses, considered the payment for order flow. Exchanges have also expressed strong views both for and against the issue of preferencing.

In a system of decimal pricing, what, in your view, would happen to these practices?

Mr. WALLMAN. The issue with regard to payment for order flow and preferencing both relate, I think, to the economics of how trading is done.

One way to look at payment for order flow at the moment is that, in essence, it is a mechanism to get in between the spread. People are saying that you have a 12.5 cent spread and we're willing to give you 2 cents back or 2.5 cents back. Consequently, it reduces the spread economically to 10 cents. So you have, in essence, sort of a decimalizing, if you will, a narrowing of the spread occurring through some of these mechanisms.

If, instead, you had real competition and allowed for the markets to go to a natural spread so that you weren't at an artificially wide spread—and that you could do through decimalization—were you to do that, then the economics in terms of incentivizing people for payment for order flow or preferencing start to be reduced.

Consequently, you would expect the problems such as payment for order flow and preferencing to the extent people view them as problems either to be reduced or, in some cases, perhaps to be eliminated.

Mr. OXLEY. Thank you.

The issue of time price priority may be complicated by a move to decimal pricing. Would you explain to the committee how trading in decimals might affect priority and what could be done to alleviate problems?

Mr. WALLMAN. The question of price/time priority is, again, sort of an interesting one.

There is some price/time priority in our markets today. There is not as much price/time priority as one might expect. There is not a great deal of linkages between the markets in terms of providing price/time priority.

There is price priority for the link markets.

The move to decimalization or the payment that the dealer would make in terms of the spread, if that were to be reduced you would have finer increments, and the thought might be that if you had finer increments you would be in a position to perhaps have less of a problem with regard to price/time priority because you would end up with an easier set of increments and finer trading so that people would be able to trade with fewer large jumps between the limit orders that they would have to put in to get ahead of another limit order.

One of the concerns that people have made with regard to price/time priority, though, is that professionals might be able to jump ahead of public orders more easily.

There are a number of answers to that. Some have simply suggested that a better price is a better price. Others have noted that

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in a dynamic market as opposed to a static market, where you have a number of orders coming in, what will occur is that if somebody has a limit order at $20.05 and a professional or someone else jumps ahead by taking out orders at $20.06 or $20.07, then another limit order comes in at $20.08 or $20.09.

The professional can try to jump ahead again, but what you do then is start to narrow the spread to zero or you're moving the market.

So, consequently, the concern, as expressed, may not, in fact, really be a concern.

Mr. OXLEY. Thank you.

The Chair's time has expired.

The gentleman from New York?

Mr. MANTON. Thank you, Mr. Chairman.

I want to address the question to Mr. Wallman. I think he's taken a particular interest in the issue.

I was contacted by our comptroller of the city of New York, Alan Hevesi, regarding an employment-related statement that he, as the steward of a large number of pension funds, wanted a place in a proxy statement—in this case, the Cracker Barrel Company proxy.

Could you talk to that set of facts and give us your feelings on it?

Mr. WALLMAN. Yes. Thank you, Congressman.

The Cracker Barrel case relates to resolutions that, under our rules relating to shareholder communications, allow proxy statements to include resolutions put on by shareholders. That's a general rule.

We have had for about 20 years a provision that said that if a resolution relates to ordinary business, that that resolution would be excludable.

We have had an exception to that which says that if it relates to ordinary business but also implicates a broad social policy, such as employment discrimination, that the resolution would then be includable.

That was the rule for almost 20 years.

In 1993, the then sitting Commission changed that and put out what is called the "Cracker Barrel" letter that you referred to, which states that, as a general matter, all resolutions relating to employment generally would be excludable, even if they relate to employment as it relates to discrimination or other broad-based social issues.

The Commission was sued in court on this matter. It then wound through the courts for a number of years. We had the opportunity to revisit that Cracker Barrel position a couple weeks ago, and the Commission decided that, based on the commencement of a study required by the national markets——

Mr. MANTON. Do you think we need a study at this point?

Mr. WALLMAN. I think that a study is a very worthwhile thing to have with regard to the broad-based issue of how to reform the proxy communication system and the proxy rules for shareholder resolutions. I think it is useful and I would certainly commend the Commission for wanting to take that step. In any event, it's mandated by the act.

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I think that the Cracker Barrel issue, however, is a separate one. Instead of having the Commission driven, in terms of its timing or policy, by having to resolve the Cracker Barrel dispute over the short term, I would rather have a study that, in the deliberative fashion that the Commission is used to, resolved the broader-based issue with regard to proxy communications of shareholder resolutions, while in the meantime resolve the issue now that's on the table with regard to Cracker Barrel—and reverse it.

It is an issue which I think is severable, and it's one which I think we can address now, and I would hate to see it either demand that the broader-based issue be resolved more quickly than we would otherwise be able or willing to do in a deliberative fashion, or to have Cracker Barrel deferred for another year or 2 as we continue to review the broader-based issue.

Mr. MANTON. Thank you. I don't want to really——

Mr. OXLEY. The gentleman's time is expired.

Mr. MANTON. I want to put one more question.

Mr. OXLEY. Go ahead.

Mr. MANTON. I don't want to beat the decimalization issue to death here, but it's a little unclear to me whether we're talking in terms of 10-cent increments or 1-cent increments. Is there a standard? Is that what they use in Toronto?

After hearing from Commissioner Wallman on that, I would like to ask the rest of the panel what their feelings are about the subject.

Mr. WALLMAN. Toronto has a ladder, and their general trading is in five-cent increments. They go down to a penny for smaller-priced stocks. So it's a laddered system.

My personal view would be that I think that you ought to have all the markets ready to be able to take quotes and display in pennies. If they wish to have established for themselves different levels of increments, that would be up to them.

But there ought to be the ability for the markets then to compete with each other, and if somebody has a narrower spread, finer increment, that ought to be shown so that you can reach that quote in whatever market is displaying.

Mr. OXLEY. Mr. Chairman?

Mr. LEVITT. I don't have any further thoughts about the issue of decimalization.

I would like to add to Commissioner Wallman's observations about Cracker Barrel that, when there are several problems with a forest you prefer to fix it one tree at a time. That's not a very good way to go, in my judgment.

This issue is so complex in terms of shareholder proposals that the Congress appropriately requested the Commission to study the issue this year. We expect to evaluate the whole landscape and address this issue, along with other related issues.

We're not talking about an extended delay. We intend to comply with the Congressional mandate in a prompt and comprehensive fashion.

We share the feeling that this is an important issue. It's a contentious issue. While it has been around for a long time, we believe that the few months left before this study is completed will be time well spent.

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Mr. OXLEY. Thank you, sir.

Mr. Johnson?

Mr. JOHNSON. This is a difficult issue and one we're very concerned about. We want to be sure that it is processed properly and dealt with fairly.

I know that Commissioner Hunt and I have been on the Commission for about a year. We have not been involved with respect to Cracker Barrel at the extent that we'd like to.

We want to become totally familiar with the problem and give it the best lick we can.

Mr. OXLEY. Thank you, Commissioner.

Commissioner Hunt?

Mr. HUNT. Mr. Chairman, I think that we ought to try to fix the whole proxy communication/shareholder communication process at one time.

I think that if we reverse Cracker Barrel tomorrow, then we would be back in the position of the Commission staff and/or the Commission doing line drawing as to what proposals should be in a particular company's proxy and what shouldn't.

I think we and our staff are uniquely unqualified to draw those lines, and so I would like to see our overall review of the shareholder communication process lead to an entirely different process.

As to the decimalization, I think the motive is to reduce the spread on the most liquid stocks in our market, and that clearly—clearly the one-eighth spread now is an artificial barrier to much smaller spreads for the most liquid stocks.

One way to do it is obviously decimalization. You can also do it by having to trade in smaller increments than one-eighth.

But I think the overall goal ought to be to reduce the spreads, particularly as to the most liquid securities in our market.

Mr. MANTON. Thank you very much. I thank the chairman for giving me a little leeway on the time.

Mr. OXLEY. Well, since you're hosting us up in the Big Apple tomorrow, I thought I'd be appropriately free with our time.

The gentleman from Ohio.

Mr. GILLMOR. I thank you, Mr. Chairman.

Commissioner Johnson, I understand you've been a strong advocate of small business capital formation. Could you tell the committee what the SEC is doing in that respect?

Mr. JOHNSON. Yes, Congressman. Thank you.

The Commission presently has a very aggressive program to support the needs of small business, and small business' efforts to raise capital.

For example, the Commission, among other things, has established a new unit dedicated to small businesses, including a review of filings and drafting of rules to lessen the regulatory burden on these issuers.

It has hosted a series of small business town hall meetings across the country in order to convey basic information to small businesses. That would be about some of the fundamental requirements involved in the capital-raising process under the Federal securities laws.

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It has supported a small business ombudsman in the division to act as a liaison and an agency spokesman for the concerns of small business.

It has expanded the Commission's web site to provide information specifically designed for small businesses.

It has raised the ceiling for exempt offerings under Regulation A from $1.5 million to $5 million.

It has adopted a shorter holding period for resales of restricted securities under rule 144.

It has permitted test-the-water solicitation for proposed Regulation A offerings. As a result of this, 85 companies have used the procedure to solicit indications of interest.

They have adopted a new exemption from 1933 Act registration requirements for small offerings.

They've doubled the total asset threshold for requiring initial registration under the 1934 Act from $5 million to $10 million.

In 1996 alone, small business issuers filed 486 registration statements on simplified forms to register approximately $10 billion in securities and 75 Regulation A offering circulars to register $257.3 million in securities.

Looked at collectively, these measures have increasingly reduced the regulatory burdens which have historically interfered with the legitimate efforts made by the small business community to raise capital.

Finally, it's my observation that all of this is a reflection of the remarkable dedication and genuine nonpartisan concern of Chairman Levitt for small business. Without him, much of this would not have happened.

Thank you.

Mr. GILLMOR. Thank you very much, Commissioner.

Chairman Levitt, what steps has the SEC taken or will it take to implement the requirement of the National Securities Market Act that the SEC consider efficiency, competition, and capital formation in its rulemaking?

Mr. LEVITT. The Commission historically, through the years, has always considered efficiency as part of its mandate. The encouragement of small business, as Commissioner Johnson has noted, the encouragement of capital formation, has always been one of the principal goals of the Commission.

I would point out that the No. 1 mandate of this Commission—I use the word "obsession" very often because I feel so strongly about it—is investor protection, and nothing, in my judgment, should come ahead of investor protection in terms of what the Commission does or how it operates.

The mandate of the Fields bill was to urge upon the Commission more emphasis on something we have done through the years, and we take that mandate very seriously.

Our Office of the Chief Economist has consistently worked on evaluating the impact of proposed rules and regulations before they are adopted. The process that the Commission uses whereby, before we implement a rule, we put it out for public comment evaluate those comments that come back to us is very much in sync with the evaluation of what its cost in terms of time and money, will be for regulated entities subject to the rule.

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When I ran a brokerage firm and when I ran a stock exchange, I dealt with my predecessor commissions, and I know first-hand what the impact of an unreasonable rule or a redundant regulation can be.

So we have been very careful in terms of approaching these issues and trying to address them by consensus.

In those instances where we deal with issues that are contentious, which seem to be most instances, we try very hard to try to solicit the broadest possible views, and then, when a rule is eventually arrived at, it's one which takes cognizance of cost and takes cognizance of alternative ways of reaching that objective; and generally speaking we use that period of time to try to mobilize the maximum support possible.

The order handling rules that the Commission recently adopted probably constituted the most contentious rulemaking effort that this Commission has engaged in since I've been there, and yet I believe that, as a result of working with our constituents, of mobiling their support, of gaining an understanding of what these rules could accomplish, we have been able—I knock wood at this point because we're only partway through the process. We have already been able to see a reduction in spreads of nearly 30 percent. That's a savings to investors of nearly 30 percent on those spreads.

The market has remained as liquid as it was before. No dealers have dropped out of the market. That is the way the process should work when it works well. Does it always work that well? Not always, but we're trying, and we're very mindful, and we think it appropriate that the admonition of the Fields bill was to emphasize this factor. It's one we take seriously.

Mr. GILLMOR. Thank you very much.

Mr. OXLEY. The gentleman's time has expired.

Mr. GILLMOR. Thank you.

Mr. OXLEY. The gentleman from Washington State, Mr. White?

Mr. WHITE. Thank you, Mr. Chairman.

Chairman Levitt, I hope you'll permit me to ask you a little bit of a philosophical question.

You made the point earlier—and I totally agree with it—that investor protection has to be the highest goal of the Commission. And Mr. Markey talked to us a little bit about a case where there had been some fraud that hadn't been detected beforehand. My own sense is that it probably is impossible to detect every instance of fraud on the market, and that's not really a realistic objective for your Commission.

It's also, obviously, impossible and probably not desirable to protect even unsophisticated investors from all the market risks that might exist in a market. A market exists, of course, because there is risk and reward.

I was intrigued by your comments earlier. You make the point that we have many unsophisticated investors in the market now, perhaps more than we've had before. We've had a 14-year bull market and that won't, of course, last forever. And I know we do need to focus on protecting unsophisticated investors.

But I guess I'd like to know your thoughts on how do you determine when you've gone far enough in terms of adjusting the mar-

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ket risk that really is the mechanism that allows a market to operate all together?

In other words, is there a point beyond which you shouldn't go——

Mr. LEVITT. Yes.

Mr. WHITE. [continuing] in trying to make sure that investors all receive a return on their investment?

Mr. LEVITT. I think very clearly that it is not the job of any Government agency to insure investors against risk. I think it is our mandate to see to it that investors are able to protect themselves, and our whole program of investor education is dedicated toward that. It's a program that's supported by the industry, as well, because the mixture of an unethical broker and an uniformed investor is costly to the system, is costly to the firms, and is costly to the whole process of capital formation.

It is not the mission of the Securities and Exchange Commission to insure investors against risk; it is our responsibility to see to it that those people who lie, cheat, and steal are not only driven out of business, but in those cases where appropriate are sent to jail.

The Commission has placed great emphasis upon doing just that. We've placed great emphasis upon seeing to it that bad brokers who prey upon the public, who steal from investors, go to jail, and that supervisors who have received warnings about unethical recidivist brokers are held accountable, as well.

But very clearly it is not a mandate of any Government agency to guarantee against risk.

Mr. WHITE. So your comments about making sure we protect unsophisticated investor primarily focused on making sure that fraudulent practices are minimized to the absolute extent possible?

Mr. LEVITT. Doing that and seeing to it that investors are fairly treated in terms of understanding products that are available to them and that competitive pressures are such that an individual investor has an opportunity that is at least as good and usually better than the dealer who sells them that product.

Mr. WHITE. Thank you.

Mr. Chairman, do I have time for one more question, or am I testing the bounds of your patience?

Mr. OXLEY. You're doing great.

Mr. WHITE. Okay. Commissioner Wallman, on this issue of decimalization, I just had a couple questions.

First, where did the one-eighth convention come from? Was this the Government that came up with this at some time in the past, or is this kind of a convention that grew up in the marketplace?

Mr. WALLMAN. My understanding is that there are a couple of different theories, but the favorite seems to be that it comes from the old pieces of eight that used to be part of the Spanish currency.

Mr. WHITE. Okay. So this isn't Congress' fault that we're in the one-eighth situation?

Mr. WALLMAN. We haven't gone back that far to check.

Mr. WHITE. We've only been around for a short period of time in comparison.

Are there any competitive forces at work that might move us toward decimalization? You know, when you have a—whether it comes from pieces of eight or anything else, when you have a con-

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vention that has been in the marketplace for a long time I think the Government ought to at least think a little bit about whether we need to impose our mandate on that. Market forces such as for foreign markets and such that you mentioned earlier might be one market factor that would move us in that direction.

My own sense is that the U.S. market is such a big factor in capital markets around the world that the fact that we use fractions and other countries use decimals probably isn't a huge disincentive for people for listing in our markets, but maybe that's wrong.

And so my question to you is: are there some competitive forces out there that might drive our markets to adopt a decimalization program on their own, or is this something that really has to come from the Government?

Mr. WALLMAN. Mr. Chairman, did you want to say something?

Mr. LEVITT. I would say that yes, there certainly are. I think our order handling rules clearly are moving us in that direction as spreads narrow. I wouldn't be surprised to see one market or another begin to quote in different ways, and I think in time market pressures will move us in that direction.

While I have the floor, I would like to add to my previous answer with respect to protecting investors, because there are two other very important areas that the Commission deals with in terms of investor protection. One would, of course, be full disclosure—seeing to it that investors have every opportunity to make reasoned judgments. And the other, which is terribly important and the highlight of our recent activities with respect to market structure, is access to markets—seeing to it that investors have fair access to markets.

Mr. WHITE. I appreciate that.

Mr. LEVITT. Good question.

Mr. WALLMAN. If I could just respond a little bit more, I agree with the chairman that some of the order handling rules will, in fact, provide pressure to try to narrow the spreads. That's what they were designed to do.

However, unfortunately there are still agreements in terms of the CQS and ITS and others that make it difficult for less than an eighth spread to be quoted and to be seen. Consequently, unless there is a change in some of that, or at least addressing some of the issues presented by those systems, it becomes difficult for competition, by itself, to work all the way through.

That's just with regard to narrowing the spread.

With regard to moving actually to decimals, again, it's the same kind of problem then unless you change some of these systems or address some of the issues raised by some of these other agreements, it's very hard for someone to provide a decimalized quote. That is invisible in the markets, generally.

Mr. WHITE. I appreciate that. Thank you, Mr. Chairman.

Mr. OXLEY. I thank the gentleman.

The gentleman from New York.

Mr. MANTON. Thank you, Mr. Chairman.

Chairman Levitt, could you discuss after-hours or no-fee trading or matching, whatever the proper words of art are, where are we on that?

Mr. LEVITT. You're asking that question in terms of whether investors——

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Mr. MANTON. Competing with other——

Mr. LEVITT. [continuing] whether individual investors have an opportunity that's equivalent to institutions that may be trading after hours.

While I have some concern about that, I believe that the movement toward after-hours trading is an important one and it's one that will be increasingly driven by globalized markets.

My feeling about whether individual investors should have access to those markets really relates to the extent to which trading in those markets is more or less liquid than the regular market trading that takes place during regular market hours. If trading is less liquid investors would be at some risk if they were able to trade in after hours markets.

But hopefully, as globalized trading systems develop, and after 24-hour trading becomes a reality, it will become a reality for institutions and individuals, alike.

Mr. MANTON. I have one last question.

I understand you've been a vocal proponent of increasing minority representation in the securities industry. You have encouraged firms to hire and promote minorities in all aspects of the securities business, not just municipal finance, an area where minority representation has been strong.

Can you share your views on this subject with the committee, please?

Mr. LEVITT. Yes, I can. I have been greatly concerned that an industry that I spent much of my life in, an industry that I today regulate and I think is vital to the future of the Nation, has been gravely deficient with respect to addressing the important issue of diversity and is behind other industries in terms of this terribly important objective.

I think what is called for here is a basic cultural change—the ability to see minorities running branch offices and communities around the country, operating in the operations departments of firms, running syndicate departments of firms, in the executive offices of firms, in places where they simply aren't present today.

There is no way, nor is it appropriate, I believe, nor do we have the authority to address this important issue, but by speaking about it, by encouraging the very thoughtful people in an industry that is as resourceful as any in America to address a problem that I think is as great as any in America, I think we can begin to address something that urgently needs addressing.

Mr. MANTON. Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. OXLEY. I thank the gentleman.

Chairman Levitt, it's my understanding that the SEC may be contemplating a proposal to regulate electronic trading systems like Bloomberg and Instinet as independent stock exchanges, subject to all of the provisions of the 1934 Act.

In 1993, as you know, the SEC rejected such an approach, concluded that these private trading systems were adequately regulated as broker/dealers.

Does the SEC have such plans? If so, what accounts for the SEC's change of heart on this issue?

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Mr. LEVITT. Well, I think that our markets have changed so much and the Commission has done so much in the area of market structure that it's very difficult for me to say that the Commission is going to stand pat and simply embrace a regulatory system that has been in place for years and years and years. We have new entrants into the market. Some of those that you have mentioned have newly appeared on the scene.

I think it fair to say that the Commission has made no determination to regulate those markets as stock exchanges necessarily, but at the same time I'd say that we clearly have to address the question of how they will be regulated. They have become factors today that simply didn't exist months ago.

So we're carefully considering what form of regulation would adhere to the objective that this Commission supports—namely, markets that compete fiercely but fairly.

We haven't made a determination as to precisely what we will do or how we will do it.

Mr. OXLEY. Do any of the other commissioners have any comments in that regard?

[No response.]

Mr. OXLEY. It's not mandatory.

Mr. WALLMAN. I agree with the chairman's views. It's a difficult issue and one that is the subject of a lot of thinking and I think probably a lot of long-term debate, as well.

It's an issue that we have to address because you can sort of take the continuum of entities that engage in very traditional broker/dealer practices and entities that engage in clearly exchange practices, and no longer is that a clear dividing line between the two. You've got many types of firms that are starting to do a little bit of each and looking, in some cases, like they're more of one than the other.

It's becoming a difficult issue and it's one that we have to address longer-term.

Mr. OXLEY. Thank you.

Chairman Levitt, I'd like to turn to the important area of derivatives—something that we've had some discussions about before.

As you know, I've been committed to keeping the over-the-counter derivatives market free from regulatory burden that would drive these transactions overseas or make them unavailable to American business.

Our good friend, the distinguished chairman of the Federal Reserve, Alan Greenspan, recently stated that, "There appears to be no need for Government regulation of off-exchange derivative transactions between institutional counter parties."

Do you believe that privately negotiated derivative contracts should be excluded from the Commodity Exchange Act?

Mr. LEVITT. We have—we, ourselves, had no plans to regulate the over-the-counter derivatives market, and therefore I would be supportive of that proposal in the Commodities Exchange Act.

We are planning to revise our rules with respect to capital to address the way risks associated with over-the-counter derivatives are treated.

Mr. OXLEY. I'm concerned that in the Financial Accounting Standards Board release on derivative accounting there's a require-

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ment that one side of a derivative mark the contract to market while the other side does not. This could severely limit the utility of these contracts for hedging because the accounting treatment will not be parallel.

Can you assure me that in considering changes to the accounting treatment of derivatives that the SEC will be careful to ensure the utility of these private contracts will remain unimpaired?

Mr. LEVITT. You're touching on a very sensitive point, and that is the point that deals with the setting of accounting standards.

Probably no issue that this Commission has faced has been more contentious than the continuing tension between the business community and the FASB.

As you know, the Commission has recently put in play a series of rules with respect to disclosure of derivatives transactions, and we gave to issuing companies three alternatives upon which to base their disclosure plans.

What the FASB is dealing with and what you're asking me about is the accounting treatment, which is a separate matter, as to how companies will be required to account for derivatives.

What is so important is that investors in companies that make use of derivatives understand the accounting implications of the use of these relatively new products.

FASB is in the midst of a process of trying to come up with the right answer from an accounting point of view. The Commission has oversight responsibility over the FASB. We try to interfere as little as possible in their efforts.

I believe that the FASB has a process which is as open and sensitive to public need as one could possibly have, and I would expect that the FASB, in working through that process, will come up with an accounting standard in connection with derivatives that will give investors the clearest possible view in terms of the implications of the use of derivatives by corporations.

Will this be acceptable to all corporations in the United States? I dare say not. The notion of accounting in terms of marking to the market has been a very difficult one for corporate America to accept. My predecessor chairman was very emphatic in his embrace of marking to the market, and so am I.

Mr. OXLEY. Let me turn to the Public Utilities Holding Company Act, something that, as you know, another subcommittee is considering the whole question of electric utility deregulation. It has a great deal of cross-interest with PUHCA.

Chairman Bliley and subcommittee Chairman Dan Schaefer have introduced legislation, and I commend the Commission for its efforts to reduce some of the regulatory burdens imposed on registered holding companies as the Congress proceeds with this important initiative.

The Commission's recent adoption of rule 58 provides a safe harbor to permit these companies to invest in energy-related companies.

What benefits do you anticipate that this rule's safe harbor will bring to these companies and their shareholders?

Mr. LEVITT. Well, as you know, the Commission embarked upon and completed an extensive study of this issue and came to the conclusion that there should be some broadening of the ability of

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utility companies to make acquisitions consistent with protection of the public, and that's something that the Commission has facilitated by streamlining the process that we'd lived with for some years.

Commissioner Hunt has emphasized and evaluated this area and, with your permission, I'd like to call upon him to define at greater length the Commission's feelings about the recommendations of both the panel, as well as the steps toward approving diversification on the part of utilities.

Mr. HUNT. Thank you, Mr. Chairman.

Mr. Chairman, the Commission promulgated rule 58, to which you referred, in an effort to update the administration of and regulation under what probably is the most restrictive statute that the Commission has under its jurisdiction. It was more than adequate for its purposes at the time it was enacted by Congress.

As the rapidly evolving utility business has been changed into becoming more competitive, it became incumbent upon the Commission to modernize its regulatory views under the 1935 Act.

As you undoubtedly know, the Commission commissioned a study of the 1935 Act under former Commissioner Roberts. It was that study that led to the promulgation of rule 58.

It allows—what the rule ostensibly does is allows registered holding companies to purchase securities of non-utility companies without prior SEC review. What that means is that the whole process of the diversification of the holding companies can now be taking place in a much shorter timeframe because they don't have to seek SEC review for every transaction.

The rule does not expand their diversification abilities. All it does is modernize the process under which they can engage in diversification activities.

We think that's important, because the over 80 percent of the utility industry that is not under the Public Utility Holding Company Act is engaging in a very rapid system of diversification.

What we're trying to do in our administration of the PUHCA is to see to it that the 13 or 14 or so holding companies under our jurisdiction can compete on a level playing field in terms of their diversification efforts.

Mr. OXLEY. That was an interesting—well, let me ask you this, Mr. Chairman. Would you agree with Commissioner Hunt that this is the most restrictive regulation that you have to deal with under the auspices of the SEC?

Mr. LEVITT. I try not to disagree with Dean Hunt.

Any law school dean, as a non-lawyer, I'm very sensitive to.

Mr. OXLEY. I think that's good advice, even for us lawyers.

Let me ask you, Mr. Chairman, have you had an opportunity to review the PUHCA provisions in the Schaefer legislation, and, if so, would you care to comment about that language?

Mr. LEVITT. No, I have not had an opportunity to do that, but I would like the opportunity of sending you a letter within the next 48 hours in terms of my personal reaction to it.

Mr. OXLEY. That would be fine.

Let me ask Dean Hunt, if the—if we just repealed PUHCA, would that be appropriate response to what is, as you indicated very properly, the change in conditions in the industry?

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Mr. HUNT. Well, sir, I think that arguably that could be. I think that many of the investor protections in PUHCA for investors are now embodied in provisions of the 1933 and 1934 Act.

There was some concern during Congress' actions last year that some of the 1933 and 1934 Act investor protections might have been eviscerated by the National Securities Market Improvement Act of last year, but that didn't happen.

So what you have is a system of strong Federal investor protection in provisions of the 1933 and 1934 Act. You've got much-more-sophisticated State utility regulators than you had at the time of the enactment of the 1935 Act, and you've got other Federal legislation and regulations such as FERC.

It arguably is the case that no investor protection nor any efficiencies in the utility industry would be affected by the repeal of PUHCA because of these other statutory—Federal and State—enactments that are now in place and arguably were not in place and certainly not as well administered in 1935 when this act was passed.

Mr. OXLEY. Thank you.

The gentleman from Ohio.

Mr. GILLMOR. Just a couple of questions, Mr. Chairman. I might direct them to the panel, whoever wants to answer.

I want to go back to the trading in fractions or decimals.

If you look in the stock market page, you will see not only eighths but sometimes in stocks trades listed at 1/16 or 1/32, which obviously would be a smaller spread.

So I guess my question is: what determines whether the trade is in 1/8, 1/16, or 1/32, and if the competitive pressures are to move you to a smaller spread, why aren't we seeing more of them traded at that level?

Mr. WALLMAN. The system currently permits trades, for example, in third markets and other markets in other kinds of increments, including 16ths and 32nds. When those trades actually occur in those increments, then they are reported, and therefore they can show up in the newspapers.

However, the current quotation systems don't allow for the price quotations—of bids and asks—in these finer increments, and consequently the real benefit for investors, especially smaller investors—because most of the trades that you see reported in those much finer increments are on systems that are primarily accessed by professionals, by larger traders, institutions, or others. The benefit for the smaller investors doesn't exist because there is no good mechanism for those much finer increments to show up in the actual quotes, which is what the smaller investor actually receives.

So it's really a question where, because of the way the markets are currently constructed, you have a subsidization in a certain sense of larger traders, professionals, by smaller traders and smaller investors.

Mr. GILLMOR. I just would seek some comments here on 12b-1, which, as I understand, is a fee that, granted, the shareholders of a mutual fund would authorize, but if I understand it correctly, it's to permit the management company of that fund—that does advertising—to get more shareholders into the fund.

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It strikes me that the current shareholders really derive no benefit as a practical matter from that, but they're bearing the cost of it, as I understand it.

So I guess some thoughts on the fairness of that situation and what, if anything, should be done about it?

Mr. LEVITT. Well, this is another one of those areas where, as strongly as I may feel about fees and what they imply, I think it's inappropriate for a Government agency to tell an enterprise what they should charge.

However, having said that, what I think is terribly important is that investors understand precisely what they are paying for.

With respect to 12b-1 fees, I believe there is some confusion about that.

I think investors simply don't understand what they are paying for, and our efforts at plain English and the profile prospectus and the much clearer display of fees will enable investors to make competitive judgments as whether fund A costs them more than fund B.

In our investor education program, our town meetings, I'd say a good 40 to 50 percent of the discussions involve mutual funds, and the message we want to drive home is that those fees are critically important and that investors should understand that even what appears to be a minute difference in fees can have an enormous impact on the results of their fund.

So the 12b-1 fee is something that we want to be certain is understood by the investing public, and we want to motivate consumers to bring the pressure on companies, which is the only pressure that should exist, to drive fees down.

Mr. GILLMOR. I agree with your statement. It's not our role to regulate those fees. I don't think it's the SEC's or Congress' role to do that, but, as you point out, it is our role to make investors aware.

My concern is that, in terms of accomplishing that mission, both on management fees, themselves, and on the 12b-1 fees we're not there and we have not been successful, although I know that you're moving in that direction and I commend you for it, but it just appears to me that the investor really doesn't have that information in a meaningful way in most cases yet.

Mr. LEVITT. I think you're correct and I think it's important that you call that to public attention. It's something that we're very concerned with.

I'd add one point relative to 12b-1 fees. They are not exclusively a marketing and advertising fees; they are also payment to brokers to service their existing clients. Nevertheless, you correctly point out that these fees are really fees that to many investors are hidden and they simply don't understand what they are, what they do, how they operate.

Mr. GILLMOR. Thank you.

Mr. OXLEY. Let me just follow up with a question on the decimalization issue.

I know in your testimony, Commissioner Wallman, you indicated that The San Francisco Chronicle had already undertaken listing stock prices by decimals; is that correct?

Mr. WALLMAN. Yes, that's correct.

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Mr. OXLEY. Are they the only ones, to your knowledge?

Mr. WALLMAN. To my knowledge they're the only major newspaper that has done that. I know that there are others that were looking at that, as well, but I think The Chronicle is still the only one that has done it.

This gets back to the competition issue. It's not easy for anyone to get to decimals in terms of simply switching the system because of the way the quotation system is set up, so it is not a matter where somebody ought to just do it and then everybody will have to follow. This is a case where, unless you actually have changes in some of the systems and agreements across the board, it really simply can't exist.

The Chronicle led the way with regard to the newspaper printing, and I think they were hopeful that others would follow suit, but that's a matter of competition among the newspapers.

I think for the moment The Chronicle still stands alone.

Mr. OXLEY. Thank you.

Let me thank you, Mr. Chairman, and all of the members of the Commission for a most enlightening hearing. This is the first of what we hope will be many hearings involving the SEC. Our subcommittee stands ready to work closely with you in investor protection and all of the myriad of issues that we have before the subcommittee.

We're honored to have you here today.

Let me say we will be keeping the record open and will be submitting some further questions for the Commission and would ask that they respond in writing at the appropriate time.

With that, this subcommittee is adjourned.

[Whereupon, at 1:12 p.m., the subcommittee was adjourned, to reconvene at the call of the Chair.]

[Additional material submitted for the record follows.]

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.
May 2, 1997

The Honorable THOMAS J. MANTON
United States House of Representatives
2235 Rayburn House Office Building
Washington, D.C. 20515

DEAR CONGRESSMAN MANTON: Enclosed are the responses to your additional questions following the SEC's March 6, 1997 hearing before the Subcommittee on Finance and Hazardous Waste. My colleague, Commissioner Steve Wallman, previously answered those questions pertaining to his testimony on converting stock quotations to decimals. He also is furnishing additional information under separate cover on his views regarding the shareholder proposal process. I hope that this additional information is helpful.

I enjoyed speaking with you at the hearing and look forward to seeing you again soon.

Sincerely,

ARTHUR LEVITT
Chairman

RESPONSES TO QUESTIONS SUBMITTED BY THE HONORABLE THOMAS J. MANTON

Question 1: With regard to the SEC survey entitled "How to Improve the hareholder Proposal Process for Shareholders and Companies":

(a) How was this survey compiled?

(b) Who was consulted regarding the questions in order to assure that the relevant questions are asked, and all sides represented?

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(c) How is the survey being distributed? Will individual shareholders, not on the internet, have access to the survey? If not, has the Commission considered ways to get the survey more widely disseminated?

(d) How will the results of the survey be tabulated?

(e) Will respondents answers be made public or be confidential? If they are public, will they be distributed?

Response: (a) The Commission staff prepared the questionnaire as part of a study of the shareholder proposal process mandated by Section 510(b) of the National Securities Market Improvement Act of 1996. Staff members involved in the preparation included, among others, a senior staff member with over twenty years experience reviewing shareholder proposals, an economist, and staff specializing in "plain English" communication.

(b) The questionnaire reflects ideas for reform that various groups have expressed over the last several years, and seeks to elicit new ideas from groups that the Commission has not heard from before. Before distributing the questionnaire, the Commission staff consulted with shareholder and corporate representatives.

(c) The Commission staff distributed thousands of paper copies of the questionnaire to individual shareholders, institutional shareholders, and both shareholder and registrant groups. The intent was to make the questionnaire as widely available as possible.

(d) Individual survey responses will be compiled and written responses will be reviewed by the Commission staff. The purpose of the survey was not to obtain a scientific sample of prevailing opinion. Among other things, the purpose was to solicit ideas and commentary from interested individuals and groups. When analyzed, this information will represent only one of the many sources of information that will be used in preparing the Congressionally-mandated study of the shareholder proposal process.

(e) Copies of completed questionnaires that are submitted to the Commission will be maintained in the SEC's Public Reference room. Although responses will not be distributed, copies will be made available to any interested party. The questionnaires will be considered in the Congressionally-mandated study of the shareholder proposal process.

Question 2: How many letters has the Commission received requesting reversal of Cracker Barrel? How many letters supporting the Cracker Barrel decision?

Response: Although we are unable to estimate the exact number of letters received in the last five years that advocated a particular position, it is fair to say that many of the letters urged reversal of the *Cracker Barrel* position. However, it was clear that most of those letters came principally from groups or members of groups that have consistently opposed this position.

Question 3: Would the Commission consider reversing the policy based on the Cracker Barrel decision prior to learning the results of the survey?

Response: During the 1997 proxy season, the Commission responded to requests to review four staff "no-action" letters implicating the Cracker Barrel position. In each case, the Commission declined to review the staff no-action response in light of the on-going Congressionally-mandated study of the shareholder proposal process. The study will address the concerns of those groups seeking reversal of the Cracker Barrel position, as well as other concerns that have been expressed by other groups.

Question 4: Is there a public policy justification for barring all employment-related issues from the proxy?

Response: The goal of the shareholder proposal rule is to permit shareholders to communicate with each other and with companies on proper matters relevant to the company and its business. The rule recognizes, however, that matters of ordinary business should be excluded as infringing on management's charge to run the day-to-day affairs of the company. How management hires, compensates, trains, and promotes the general work force was determined to come within that category, unlike areas such as executive compensation and corporate governance.

The 1992 *Cracker Barrel* position, which implicates only those employment-related proposals tied to social issues, provided a clearer, more predictable, framework for addressing these proposals. The Commission understands the concerns of those who seek to reverse *Cracker Barrel,* and it will re-evaluate this position and others as part of its comprehensive study of the shareholder proposal process.

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.
April 23, 1997

The Honorable THOMAS J. MANTON
2235 Rayburn House Office Building
Washington, D.C. 20515

DEAR REPRESENTATIVE MANTON: Thank you for your ongoing interest and active involvement in the subject of decimalizing the U.S. equity markets. Due apparently to a miscommunication, I learned only late last week of your follow-up questions to the Commission's testimony at its Reauthorization Hearing on March 6, 1997. I have provided below responses to the three questions you had pertaining to my remarks at the hearing about the benefits of decimals.

You asked about my estimate of cost savings from decimalizing. The reference I made to an estimate of $1.5 billion in potential savings to investors from decimals was premised on trading volume for the markets. In 1996, for example, about 250 billion shares were traded in our equity markets. Based on available information it appears that about 150 billion of the 250 billion shares involved trades where investors would be *directly* benefitted if the spread were to narrow (see below for a further description). Assuming a reduction of a penny off the bid and off the ask of the mean effective spread, this leads to the $1.5 billion estimate. (You should note that at the hearing I used the shorthand of a penny reduction in the "spread" for this estimate, a reduction of a penny off the bid and off the ask of the mean effective spread is a better and more precise description of the assumption underlying my estimate.)

As you know from the recent hearings on H.R. 1053, although my estimate is a rough one, it is in line with the views of others who have looked at the issue. For example, in 1992 Professor Peake estimated a savings of about $1 billion for every penny saved in the spread. At that time, the number of shares traded in our equity markets was just over 110 billion shares, which is less than half of today's market volume. Others place the savings in the same general range. Analyzing the savings from decimalizing just the New York and American Stock Exchanges, Jeff Ricker posits a total of $2.25 billion per year for a two cent decline in the spread. Mr. Ricker's analysis does not include the savings that would be generated from narrower spreads in the Nasdaq market.

More recently, the Toronto Stock Exchange ("TSE") estimated the savings to investors as a result of their conversion from eighths to decimals—just in the Toronto 35 Index Stocks—to exceed $110 million (Cdn. $150 million). For comparative purposes, this savings was based on a volume of 3.1 billion shares (roughly 1.5% of total U.S. trading volume, and approximately one-third of the Dow Industrial 30 trading volume). The TSE found that overall spreads decreased approximately $.05 in these stocks. Professor Harris, who focussed, for his estimates of exchange volume, exclusively on specialist trading has suggested in a recent letter savings for the U.S. markets in the general range of about $300 million per penny of reduced overall spread (equal to $300 million per each *half* penny saved off the bid and off the ask of the mean effective spread). Using the TSE overall spread reduction of about $.05, even Professor Harris' estimate, which I believe to be very conservative as noted below (and which Professor Harris thinks may still be too high), would provide a benefit for public investors of about $1.5 billion ($300 million per penny times five cents). Regardless then of whether my $1.5 billion estimate is low or high, the likely savings to investors from a decimal system are very substantial—especially since these savings recur, each year every year.

You also asked whether my estimate takes into account customer-to-customer trading. As you note in your letter, a great number of trades on the New York and American Stock Exchanges, among others, involve public customers trading with other public customers. In such circumstances any gain to one public customer from narrower spreads would be offset by a lost benefit to the public customer on the other side of the trade. In those cases, the effect of decimalization stemming from narrowing the spread would be neutral (there are, of course, other benefits). Thus, recognizing this, in making my rough estimate of investor savings, I focused initially on those trades (approximately 20% of the total trades on the NYSE, AMEX, and other exchanges) that involve a public customer trading with a specialist. Similarly, I excluded dealer-to-dealer trades on Nasdaq in arriving at my estimate.

It is overly conservative, however, to focus for exchange volume exclusively on specialist trading. The reason is that some of the trades categorized as customer-to-customer by, for example, the New York Stock Exchange, actually involve a broker-dealer that is a member of the exchange acting as principal or a member representing another broker-dealer. In particular, if a public customer order trades

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against the order of such a broker-dealer (just not the specialist), the transaction is nevertheless categorized by the exchange as a customer-to-customer trade—even though it is a trade between a broker-dealer and a public customer. And public customers trading with broker-dealers other than the specialist still benefit from narrower spreads. Consequently, categorizing all trades not involving a specialist as "customer to customer," for this purpose at least, would be incorrect. The amount of member trading on the NYSE in 1995 (the most recent NYSE Fact Book) was 34.3 billion shares and although the percentage of this amount that involves members trading with public customers is uncertain, certainly some of it does. When some of this volume is added to the customer-to-specialist trading on the exchanges and the customer-to-dealer trading on Nasdaq, one reaches approximately 150 million shares directly benefitted by a reduction in spreads, without including trades between true public customers. Thus, only a portion of the savings to investors would be expected to come from exchange specialists.

In addition, and of course, my estimate does not take into account economic savings that would accrue from greater efficiency, enhanced transparency, reduced quote volatility, etc. that would be expected to accompany a more competitive pricing system. Nor does my estimate include the elimination of ongoing costs that all market participants (including individual investors, newspapers, etc.) currently have to pay and will continue to have to pay in order to convert from decimals to fractions and back to decimals or that brokers and other professionals have to pay and will continue to have to pay to maintain dual fraction (for U.S. securities) and decimal (for everything else) trading, analytic, and reporting systems.

As you indicated in your final question, a number of witnesses at the hearing noted that market depth declined as a result of the Toronto Stock Exchange's conversion to decimals. It is true that quoted market depth declined on the TSE after the conversion. But this is, of course, expected. Specialists and dealers *should* be stating a willingness to sell more stock at a higher price than at a lower price, and they *should* be stating a willingness to buy more stock at a lower price than at a higher price. The real question is whether actual depth (which includes the depth of orders behind the new narrower increment) or overall market quality has suffered. In this regard, Susan Crocker, Senior Vice President of the TSE, testified that decimalization leads to "a reduction in 'book liquidity' as represented by the size shown at the best bid and offer. This was expected. *Total market liquidity has not, however, declined*" (Testimony of Susan Crocker, Executive Summary at 2, emphasis added.) The relationship between narrower increments and smaller quotation sizes also has been recognized in prior research conducted by Professor Harris, where he indicates that a reduction in displayed quotation size does not necessarily indicate a decrease in market depth. (Harris, *Minimum Price Variations, Discrete Bid-Ask Spreads, and Quotation Sizes,* The Review of Financial Studies vol. 7 at 176 (Spring 1994)) Finally, Professor Bacidore's testimony regarding his research on the TSE indicates that the decline in quoted depth is not necessarily evidence that liquidity has been adversely affected because of the concurrent decline in spreads on that exchange. (Testimony of Jeffrey Bacidore, at 2-3) In fact, he testified, and his study concluded, that liquidity on the TSE was *not* adversely impacted by decimalization. In his discussion paper on his research, Professor Bacidore notes that for stocks priced above $5.00 per share, market quality (measured by considering both changes in depth and reduced effective spreads) improved following decimalization. Bacidore, *The Impact of Decimalization on Market Quality: An Empirical Investigation of the Toronto Stock Exchange* (Discussion Paper at 14) (February 1997).

Congressman Manton, a number of differing perspectives were expressed during the recent Subcommittee hearings, and I hope my views are useful to you as you consider the merits of H.R. 1053. Moving to decimals presents great benefits for investors and others. This bill gets us there without mandating any particular minimum trading increment, and with the Commission being provided complete flexibility to determine how and when the conversion would occur, which should eliminate any concern over rushing the conversion at a time when the markets may be focussing on other changes. I hope you will support it. If I can be of any further assistance, please let me know. I would be pleased to meet with you on this matter and discuss it in detail with you.

Very truly yours,

STEVEN M.H. WALLMAN
Commissioner

cc: The Honorable Michael G. Oxley, Chairman
The Honorable Arthur Levitt

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
May 6, 1997

The Honorable THOMAS J. MANTON
United States House of Representatives
2235 Rayburn House Office Building
Washington, D.C. 20515

DEAR REPRESENTATIVE MANTON: As referenced in Chairman Levitt's response to your questions regarding shareholder proposals, the *Cracker Barrel* position, and the SEC survey, I am writing separately to express my personal views.

As you may be aware, I dissented from the denials of requests for review of *Cracker Barrel* received this proxy season.[1] I see no public policy justification for barring all general employment related issues from the shareholder proposal process. In fact, for years before *Cracker Barrel* in 1992, the Commission and its staff took the position that employment related proposals were not excludable under the "ordinary business" exclusion if they related to a significant public policy issue. While the *Cracker Barrel* position may provide a "clearer, more predictable framework" for addressing employment related proposals, so would permitting all shareholder proposals. Maintaining *Cracker Barrel* is not the right answer from a public policy perspective.[2]

I also have concerns about the use of the questionnaire. Congress mandated in NSMIA that the Commission engage in a study to review shareholder access to the proxy statement. Although a study was mandated, a questionnaire and further delay were not. Moreover, shareholder representatives have questioned the methodology of the questionnaire, and the usefulness of the information to be obtained (copies of letters enclosed). The complaints are justified.

I remain quite concerned then regarding the timing of reversing *Cracker Barrel*. Given the months already spent on the questionnaires, and the time still to be spent analyzing them, coupled with the likely schedule for completing the study and reviewing the broader issues, I am skeptical that any broad-based reform proposal that would address *Cracker Barrel* could be implemented in time for *next* year's proxy season. And if roundtables, concept releases or other actions are required to complete the study (particularly if the questionnaires lack utility), it will be impossible to reverse *Cracker Barrel*—as part of any broader reform—in time for next year.

Thus, *Cracker Barrel* would remain in place for *still another year*. The process either needs to be accelerated greatly if a reform proposal is realistically to be implemented in time for next proxy season or, alternatively, *Cracker Barrel* should simply be reversed.

If there is any further information you desire or if I can be of any further assistance, please let me know.

Very truly yours,

STEVEN M.H. WALLMAN
Commissioner

Enclosures

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[1] Enclosed is a copy of my dissent and an addendum to my dissent setting forth my objections.

[2] Just since last fall, my office has received over 600 letters from more than 300 separate individuals or groups urging the reversal of the *Cracker Barrel* position. These letters came principally from groups or members of groups that have consistently opposed this position. To date, I have received relatively few letters supporting *Cracker Barrel*

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE SECRETARY

April 8, 1997

Paul M. Neuhauser, Esq.
3485 Richard Circle, S.W.
Iowa City, Iowa 52240

Dear Mr. Neuhauser:

This is in response to your letter of March 18, 1997 requesting, on your client's behalf, that the Commission review the position of the Division of Corporation Finance with respect to the application of Rule 14a-8(c)(7) under the Securities Exchange Act of 1934 to a proposal submitted to Woolworth Corporation (the "Company"). That proposal requested a report on the Company's affirmative action policies and programs.

Pursuant to 17 C.F.R. section 202.1(d), the Division presented the matter to the Commission for review. The Commission has determined not to review the Division's no-action position in light of the ongoing congressionally-mandated study of the shareholder proposal process.

Enclosed is a separate dissenting statement and addendum by Commissioner Steven M.H. Wallman.

Sincerely,

Jonathan G. Katz
Secretary

Enclosure

cc: Sheilagh M. Clarke, Esq.
Woolworth Corporation
Woolworth Building
233 Broadway
New York, N.Y. 10279-0003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE SECRETARY

April 8, 1997

Paul M. Neuhauser, Esq.
3485 Richard Circle, S.W.
Iowa City, Iowa 52240

Dear Mr. Neuhauser:

This is in response to your letter of March 12, 1997 requesting, on your client's behalf, that the Commission review the position of the Division of Corporation Finance with respect to the application of Rule 14a-8(c)(7) under the Securities Exchange Act of 1934 to a proposal submitted to Cypress Semiconductor Corp. (the "Company"). That proposal requested a report on the Company's affirmative action policies and programs.

Pursuant to 17 C.F.R. section 202.1(d), the Division presented the matter to the Commission for review. The Commission has determined not to review the Division's no-action position in light of the ongoing congressionally-mandated study of the shareholder proposal process.

Enclosed is a separate dissenting statement and addendum by Commissioner Steven M.H. Wallman.

Sincerely,

Jonathan G. Katz
Secretary

Enclosure

cc: Larry W. Sonsini, Esq.
Wilson Sonsini Goodrich & Rosati
650 Page Mill Road
Palo Alto, CA 94304-1050

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE SECRETARY

April 8, 1997

Paul M. Neuhauser, Esq.
3485 Richard Circle, S.W.
Iowa City, Iowa 52240

Dear Mr. Neuhauser:

This is in response to your letter of March 12, 1997 requesting, on your client's behalf, that the Commission review the position of the Division of Corporation Finance with respect to the application of Rule 14a-8(c)(7) under the Securities Exchange Act of 1934 to a proposal submitted to American International Group, Inc. (the "Company"). That proposal requested a report on the Company's policies to address "glass ceiling" issues.

Pursuant to 17 C.F.R. section 202.1(d), the Division presented the matter to the Commission for review. The Commission has determined not to review the Division's no-action position in light of the ongoing congressionally-mandated study of the shareholder proposal process.

Enclosed is a separate dissenting statement and addendum by Commissioner Steven M.H. Wallman.

Sincerely,

Jonathan G. Katz
Secretary

Enclosure

cc: Kathleen E. Shannon, Esq.
American International Group, Inc.
70 Pine Street
New York, N.Y. 10270

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ADDENDUM TO DISSENT OF COMMISSIONER STEVEN M.H. WALLMAN

The Commission has received three new requests from shareholder resolution proponents seeking Commission review of certain no-action letters issued by the Division of Corporation Finance. The letters were issued to Cypress Semiconductor Corporation, Woolworth Corporation, and American International Group, Inc. (AIG). In these letters, the Division concurred in the exclusion of shareholder proposals[1] from the respective companies' proxy statements on the ground that they relate to "ordinary business" and are excludable under Exchange Act Rule 14a-8 (the "Rule"). As in the recent case involving Allied Signal Inc.,[2] the Commission is denying the requests for review in light of the ongoing congressionally mandated study of the shareholder proposal process. And, as with Allied Signal, I once again respectfully dissent from the denial of the requests for review. Attached is my dissent in Allied Signal explaining the reasons for my dissent here, along with the following additional observation.

Reversing Cracker Barrel Should Not Be Delayed Pending Completion of the NSMIA-mandated Study. With these requests for appeal, as with Allied Signal, the Commission -- now consisting of new Commissioners -- was presented with the opportunity to reverse Cracker Barrel on the merits. My colleagues have chosen to defer reconsideration of Cracker Barrel in light of the ongoing study of the shareholder proposal process mandated by Congress under NSMIA. With great respect for my colleagues, I do not agree with their decision to wait. In my view, Congress ordered a study of whether access to the proxy statement was *impaired*, specifically by regulatory changes such as Cracker Barrel, and on shareholders' ability to include proposals relating to corporate practices and social issues. And it seems clear to me that the study was ordered *because* of this Commission's failure -- continuing over four years -- to reverse Cracker Barrel. Simply put, a study was mandated, further delay was not. To use the study now as a shield against reversing Cracker Barrel is wrong.

I also remain concerned regarding the overall timing of reversing Cracker Barrel. As a longtime advocate of efforts to revamp the shareholder proposal process, I understand the difficulty in reformulating the entire system. Nevertheless, I believe there are some reasonably straightforward solutions that could gain mainstream acceptance and consensus. But given the current likely schedule for completing the study and reviewing the broader issues, I am skeptical from a practical perspective that any broad-based reform proposal that would address Cracker Barrel as well could be implemented in time for next year's proxy season. Thus, Cracker Barrel would remain in place for *yet another year*. For that reason, too, I dissent from the continuing delay in reversing Cracker Barrel.

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[1] The Cypress Semiconductor and Woolworth proposals seek reports on the companies' affirmative action policies and practices. The AIG proposal seeks a report on the company's policies and practices to prevent discrimination against women.

[2] On February 24, 1997, the Commission denied a request for review of a no-action letter issued to Allied Signal Inc. "in light of the comprehensive study of Rule 14a-8 and the shareholder proposal process mandated by Congress under Section 510(b) of the National Securities Markets Improvement Act of 1996 [(NSMIA)]."

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In sum, Cracker Barrel should be reversed now, shareholders should be given back their right to vote on these measures, and the study can continue towards a more general rulemaking in due course. If Cracker Barrel is not reversed now, the study process should be accelerated so that any reform proposal realistically can be implemented in time for next proxy season.

DISSENT OF COMMISSIONER STEVEN M.H. WALLMAN

The Commission has received requests from shareholder resolution proponents seeking Commission review of certain no-action letters issued by the Division of Corporation Finance. The letters were issued to GTE Corporation, Shoney's Inc., Exxon Corporation and AlliedSignal Inc. In these letters, the Division concurred in the exclusion of shareholder proposals[3] from the respective companies' proxy statements on the ground that they relate to "ordinary business" and are excludable under Exchange Act Rule 14a-8 (the "Rule"). Three of the four requests for review have now been withdrawn because the *proponents* obtained the relief they requested.[4] Nevertheless, this position continues to pose ongoing problems and such appeals will continue to be justified in the future. Therefore, I respectfully dissent from the denial of the remaining request for review.

Introduction. The Rule is the principal means pursuant to which shareholders submit resolutions to a corporation for inclusion in the corporation's proxy statement. Since at least 1976, the Commission and its staff consistently took the position that shareholder resolutions related to significant social policy issues implicated by a company's business operations were required under the Rule to be included in that company's proxy statement. It did so in accordance with an explicit position set forth in a 1976 Commission release. In 1992, however, without any prior notice and comment under the Administrative Procedures Act ("APA"), the Division announced, and the Commission subsequently affirmed, a major reversal in the Commission's administration of the Rule. In Cracker Barrel Old Country Stores, Inc. ("Cracker Barrel"), the Commission determined that, at least as far as Commission action was concerned, there would now be excludable under section (c)(7) of the Rule any resolutions involving a significant social issue focussed on employment. This blanket position on such proposals remains in place, and the Commission's determination not to hear the remaining appeal indirectly reaffirms and continues the Cracker Barrel position at the highest Commission level.

Cracker Barrel Is Bad Policy. I agree that Rule 14a-8 has not been working well and must be

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3 The Shoney's and GTE proposals seek reports on the companies' affirmative action policies and practices. The Exxon proposal seeks a report on the company's policies and practices to prevent discrimination against women. The AlliedSignal proposal focuses on wage levels and other employment matters for the company's foreign operations.

4 The Commission has been notified by the proponents that the requests for review regarding GTE, Shoney's and Exxon have been withdrawn since either the company has agreed to supply the information requested in the shareholder proposal, has agreed to include the shareholder proposal in the company's proxy statement, or has been generally responsive to the proponents' concerns.

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changed. In fact, I have been the primary proponent to change the Rule.[5] But continuing the Cracker Barrel position is not the proper way to effect appropriate change. Simply put, it is difficult to view resolutions relating to such high profile and important public policy matters as discriminatory hiring policies as relating to "ordinary business," especially when recent experiences like Texaco, Shoney's, Mitsubishi and Publix Supermarkets are considered.[6]

Even the business community itself does not countenance this view and, except rarely, refuses even to make the argument. Despite Cracker Barrel, proponents continue to submit resolutions to companies involving core Cracker Barrel issues -- issues relating to discriminatory hiring practices. And despite Cracker Barrel, in almost all these cases, the companies either accept the resolutions, or proceed even further and provide the requested information. As I have been informed, in 1996, 22 of these resolutions were proposed,[7] and 19 of the 22 were either included by registrants in their proxy materials, or the proponents obtained an agreement from the company to produce the requested information and withdrew the resolutions. In 1997, it appears that -- so far -- at least 42 such resolutions have been submitted (an increase from the pre-Cracker Barrel days); clearly, proponents are not deterred by Cracker Barrel from submitting resolutions.[8] And, again, Cracker Barrel is not resulting in the resolutions being omitted: three of the four instances that were the subject of the current requests for review have been resolved to the proponents' benefit -- and those three appeals are now moot. Given that most Cracker Barrel-type resolutions submitted in the post-Cracker Barrel era are resolved as the proponents wish, it appears that registrants agree that Cracker Barrel is bad policy and assign it no weight.

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[5] I have outlined a proposal for significantly modifying Rule 14a-8 to avoid the Commission having to make these types of judgments in the future -- judgments the Commission is ill-equipped to make. *See*, Remarks of Commissioner Wallman before the Council of Institutional Investors on October 8, 1996. In addition, in other contexts, I have suggested that shareholder proposals could be subject to a system where determinations as to what would be included would be determined by state law as a matter of corporate governance, or by shareholders and corporations through shareholder adopted by-laws provisions (with current Rule 14a-8 as a default if no such by-law is adopted).

[6] "Task Force Urges Workplace Changes at Mitsubishi," Wash. Post, at C1 (Feb. 13, 1997); "Breaching Race, Gender Barriers: The Spectre of Bad Publicity, Boycotts and Falling Share Prices Has Made Workforce Diversity a Matter of Serious Business," Fin'l Post, at 69 (Feb. 6, 1997); "Supermarket Chain to Pay $81 Million to Settle a Bias Suit," N.Y.Times, at 1 (Jan. 25, 1997); "Texaco Was Just the Beginning," Bus. Wk., at 34 (Dec. 16, 1996); "Texaco Settles Race Bias Suit; $176 Million Payment is Largest Ever," Wash. Post, at A1 (Nov. 16, 1996); "Chain Providing $96 Million for Minorities," N.Y.Times, at A12 (Jul. 26, 1995).

[7] Three other resolutions were omitted on unrelated grounds.

[8] Other types of resolutions not related to employment discrimination (such as labor issues in various foreign countries, or principles of global conduct or matters relating to practices in Northern Ireland) also may be included within Cracker Barrel's sweep. So far, the total number of these other resolutions for 1997 is approximately 27.

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What the Commission's policy *does* do, however, is shield those few companies at the edge from acting responsibly or having to respond to their shareholders' views. Even worse though, for an agency committed to protecting shareholder interests, this position evidences a lack of concern for the basic shareholder right of being able to voice an opinion on matters that are important to the company and its bottom line. And if there are any who believe that these issues do not affect a company's performance or shareholder economic interests, they need look no further than Texaco or Shoney's for very recent proof.

Finally, it is strange that the Commission could possibly believe that this is the right judgment from a husbanding of resources perspective for the Commission or any of those this decision effects.[9] The uncertainty caused by Cracker Barrel merely creates extra costs for all concerned. These costs include not only attorneys' time (for those engaged in appeals and, ultimately, the inevitable lawsuit that will be prepared and possibly filed by a proponent if the registrant fails to comply with its Rule obligation to include a proposal that would not be excludable notwithstanding Cracker Barrel) but also the Commission time in responding to this issue, including responding to Congress (which has now required a study on the matter), and responding to or processing the literally hundreds of letters Commissioners have received regarding this issue.[10] There is also a cost imposed on our credibility and integrity with numerous constituencies -- for a federal agency to declare employment discrimination "ordinary business" is untenable. For the sake of what then -- given the overall very small number of companies involved, the lack of support for such an extreme position even in the registrant community, and the almost infinitesimal number of resolutions that are, at the end of the day, actually omitted under Cracker Barrel -- have we imposed all these burdens and created such a public furor?

Maintaining The Cracker Barrel Position Is Bad Policy That Imposes Costs With Little Benefit for the Registrant Community -- When Reviewed By A Court, It Should Be Given No Weight. Cracker Barrel reversed a long-standing rule of the Commission. All agree the "sea change...[effected by Cracker Barrel] abandoning [the Commission's] former policy regarding proxy inclusion requirements"[11] was, under the APA, the legal creation of a "rule." The rule articulated by Cracker

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[9] Some may believe that, by preserving Cracker Barrel, we place pressure on proponents to support a more global fix to the problems posed by Rule 14a-8. Cracker Barrel is but one discrete and severable glitch in the shareholder proposal process. In the absence of Cracker Barrel, proponents still have many other significant issues on their agenda, and with Cracker Barrel, registrants also have other issues. This Commission has traditionally had the strength and fortitude to take action to protect the public interest, notwithstanding industry or political opposition. I see no difference here. I have faith that were we to conclude that there is a better approach to shareholder access we would proceed to adoption, even if one side or the other was opposed. Thus, I cannot subscribe to an approach of doing something in order to maintain pressure on one group or another to come to a bargaining table.

[10] My office alone has received over 600 letters since last fall.

[11] *NYCERS* v. *SEC*, 45 F.3d 7, 12 (2d Cir. 1995).

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Barrel is either "legislative" or "interpretive."[12] If legislative, the rule would be improper as not adopted in accordance with the APA.[13] The Second Circuit, however, held the rule to be "interpretive," concluding that no-action letters such as Cracker Barrel are non-binding statements of intent not to prosecute a potential rule violation. As such, the rule as articulated in Cracker Barrel should "have no binding authority" and should not be "accord[ed] great deference."[14]

Rule 14a-8 embodies a careful balancing of interests. Registrants have generally sought *not* to have *any* shareholder resolutions. Shareholder proponents have sought to have all sorts of resolutions included. Over the years there have been numerous efforts to modify the Rule, taking into account the competing interests of the various constituencies. What exists is the delicate balance crafted by Rule 14a-8. To the extent *any* deference is paid to Cracker Barrel, it materially modifies Rule 14a-8's balance.

If a court wishes to accord Cracker Barrel *no weight whatsoever* in interpreting whether a registrant is complying with Rule 14a-8, then I would agree Cracker Barrel should be viewed as "merely express[ing] the view of the Division's staff that it lacks the necessary expertise...and does not expect to allocate its limited resources..." to this issue.[15] In that instance, Cracker Barrel becomes somewhat irrelevant because it would be clear that, under Rule 14a-8 as it stood before Cracker Barrel, most resolutions of the type that were appealed to the Commission for review would be required to be included in the registrants' proxy statements. Admittedly, the Cracker Barrel position may require a proponent to sue the registrant to enforce Rule 14a-8 instead of having the Commission act on the proponent's behalf, but at least the balance originally provided in Rule 14a-8 and maintained for a score of years would not be destroyed. To the extent, however, that Cracker Barrel *is* given any weight or deference, that balance is upset, thereby quite effectively amending Rule 14a-8 and modifying the respective rights and obligations of the various parties. In that instance, it is clearly "legislative" and improperly issued.[16]

The bottom line is that the Cracker Barrel position serves little purpose, imposes costs and embodies bad policy. The Commission should accept the appeals and reverse Cracker Barrel.

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12 *Id.*

13 *Id.* at 11-12.

14 *Id.* at 14.

15 *Id.*

16 The Second Circuit concluded it would not afford Cracker Barrel "great deference," and would even afford it "less deference than other interpretive rules." *Id.* It is not clear what all that means -- but given the Second Circuit's opinion, I would assume it must mean that Cracker Barrel is basically to be viewed as an interesting letter to read, but not much else, when making a determination as to whether a registrant has complied with Rule 14a-8.

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COUNCIL OF INSTITUTIONAL INVESTORS

Suite 512 • 1730 Rhode Island Avenue, N.W. • Washington, D.C. 20036 • (202) 822-0800 • Fax (202) 822-0801

March 5, 1997

Jonathan G. Katz, Esq.
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

File No. SJ-5-97

Dear Mr. Katz:

Members of the Council of Institutional Investors, an association of more than 100 public, corporate and union pension funds with more than $1 trillion in investments, respectfully submits the following response to the Securities and Exchange Commission's survey on the shareholder proposal process.

Council members have a number of concerns about this survey. First, since the SEC is not using any sampling techniques to create a representative sample of the participants in the shareholder proposal process, the survey results may be skewed toward the views of the issuer community.

Only a small number of shareholders file resolutions each year. Many more companies receive resolutions, however, since shareholder proponents frequently submit proposals to more than one company. For example, so far in 1997, 19 Council members have filed resolutions at about 90 companies.

Without the use of any sampling techniques, the survey becomes a popularity contest controlled by the constituency with the most responses. This outcome is inherently unfair. Valid views of the minority of the respondents should given the same consideration as the opinions of the majority.

Second, the survey appears to serve no useful purpose. Presumably the issuer community will continue to favor reducing the types of proposals that must be included in proxy materials, while shareholder proponents will continue to support liberalizing the rule to allow more resolutions covering a broader range of issues.

This approach does not appear to be a recipe for meaningful change. Although most participants agree that the current shareholder proposal process could be updated and improved, the survey results could be used to justify the continuation of the current system.

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Third, most of the alternatives addressed in the survey have been introduced in the past, and none have enjoyed significant consensus. Council member thoughts on the various alternatives are detailed below:

> *Company-created system:* Council members do not support any type of company-created, shareholder-approved proposal process. This approach would create a chaotic variety of different rules to govern shareholder access to proxy materials. Costs to shareholder proponents would increase significantly, as shareholders would have to comply with different rules for each company.
>
> *State-determined system:* This criticism also applies to a state-determined system. This approach could create 50 sets of different laws for submitting shareholders. Shareholders would have to deal with the nuances between different state laws.
>
> *Separating shareholder and management proposals:* Council members believe that shareholder and management proposals should be included in one set of proxy materials and on one proxy card. Separating the proposals would unnecessarily complicate the current system.
>
> *Lottery system:* A straight numeric cap on resolutions could undermine the entire system by opening up ballots to frivolous proposals.

Fourth, Council members believe that a consensus for reforming the shareholder proposal process can be reached. One will not be reached, however, through this survey.

On Oct. 8, 1996, SEC Commissioner Steven M. H. Wallman introduced a proposal for reforming the shareholder proposal process. He designed the model to tackle two problems with the current system—the "lack of a guiding principle and a heavy reliance on subjective line drawing" by the SEC staff.

Shortly after Commissioner Wallman unveiled his proposal, the Council organized a conference call with a broad group of participants involved in the process. The working group of shareholders and corporations reached an agreement in principal on the alternative model proposed by Commissioner Wallman. In the opinion of the working group, the consensus agreement is substantially superior to the current rule. A draft of the proposed changes is attached.

The Council appreciates the opportunity to transmit to the Commission its members' concerns regarding the survey.

Sincerely,

Sarah A.B. Teslik, Esq.
Executive Director

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Charles F. Noyes, Founder

o East 39th Street, 12th Fl.
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Jonathan G. Katz, Esq.
Secretary
Securities and Exchange Commission
450 5th St., NW
Washington, DC 20549

March 31, 1997

Re: File Number S-5-97

Dear Mr. Katz:

Under separate cover we have sent you a copy of our completed questionnaire considering changes in Rule 14a-8 of the Securities and Exchange Act of 1934. Since there was no place in the questionnaire to respond to the process I am sending you this letter.

For a survey to be an effective instrument in policy making it is necessary to know the universe of individuals and institutions that you want information from, and to ensure to the degree possible that the responses represent a reasonable balance among the differing points of view that might be anticipated. Any analysis of the present survey because it does not reflect any sample cannot be considered to be valid for policy purposes. At best the survey might be used to frame the issues for future surveys that are done on a more scientific basis.

Beyond the issue of methodology there is the important issue of substance.

The proposed changes in SEC regulations as implied in the questionnaire are anti-democratic. They will favor issuers and large institutions. Smaller shareholder groups will, in effect, be cut out from the play. This is not appropriate from the point of view of insuring corporate accountability and transparency. In addition it may limit shareholders from expressing their concerns for needed changes that in the long run will be beneficial to the corporation.

A case in point is the Noyes Foundation's shareholder resolution with Intel. The resolution was filed after dialogue failed to achieve a satisfactory conclusion for the Foundation and the grantee organization it was supporting, The SouthWest Organizing Project. At the time we filed our resolution we had only 100 shares. Ultimately our effort to get Intel to share information with communities was successful when, after refiling, Intel changed its Environmental, Health and Safety Policy. The process was effective for the community, in getting information it needed, for the Foundation in encouraging greater

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accountability on the part of Intel, and seemingly for Intel as well. In a letter to Foundation News responding to an article I wrote on the resolution process, they indicated that it had been a valuable process for them.

We are pleased that the SEC is taking the matter of reform of the shareholder process seriously. We urge, however, that the approach be more systematic and democratic.

The Jessie Smith Noyes Foundation is a philanthropic foundation with 65 million dollars in assets. In an effort to reduce the dissonance between our asset management and grantmaking values we screen our portfolio, are involved in mission-related venture capital, and are active shareholders on behalf of our grantees.

We wish you well in your efforts. We would be pleased to participate further to ensure that any reform contribute to the democratic process.

Respectfully submitted:

Stephen Viederman
President

CC: Steven M. H. Wallman, Commissioner

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COMPTROLLER OF THE CITY OF NEW YORK
1 CENTRE STREET
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(212) 669-3500

ALAN G. HEVESI
COMPTROLLER

March 20, 1997

Jonathan G. Katz, Esq.
Secretary
Securities & Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

File No. S-5-97

Dear Mr. Katz:

I am the investment adviser and/or trustee for five defined benefit plans, one 457 defined contribution plan and one 403(b) defined contribution plan, with aggregate assets totaling some $80 billion. I respectfully submit the following response to the Securities and Exchange Commission's survey on the shareholder proposal process. I am very familiar with the shareholder proposal process, both through the various New York City funds, and through my work as the Co-Chair of The Council of Institutional Investors, an association of more than 100 public, corporate and union pension funds with more than $1 trillion in investments.

I have a number of concerns about this survey. First, since the SEC is not using any sampling techniques to create a representative sample of the participants in the shareholder proposal process, the survey results may be skewed.

Only a small number of shareholders file resolutions each year. Many more companies receive resolutions, however, since shareholder proponents frequently submit proposals to more than one company. For example, so far in 1997, 19 of the Council of Institutional Investors members have filed resolutions at about 90 companies.

Without the use of any sampling techniques, the survey could become a popularity contest controlled by the constituency with the most responses. This outcome is inherently unfair.

Second, the survey may not serve any useful purpose. Presumably the issuer community will continue to favor reducing the types of proposals that must be included in proxy materials, while

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shareholder proponents will continue to support liberalizing the rules to allow more resolutions covering a broader range of issues.

A survey approach does not appear to be a recipe for meaningful change. Many participants agree that the current shareholder proposal process could be updated and improved, but how to do that cannot be made apparent through a survey; crafting a complex regulatory compromise in this manner is the equivalent of creating legislation through the use of sound bites.

Third, most of the alternatives addressed in the survey have been introduced in the past, and none have enjoyed significant consensus:

> Company-created system: I do not support any type of company-created, shareholder-approved proposal process. This approach would create a chaotic variety of different rules to govern shareholder access to proxy materials. Costs to shareholder proponents would increase significantly, as shareholders would have to comply with different rules for each company.
>
> State-determined system: This criticism also applies to a state-determined system. This approach could create 50 sets of different laws for submitting shareholders. Shareholders would have to deal with the nuances between different state laws and corporations might even relocate to states with the most restrictive shareholder rules.
>
> Separating shareholder and management proposals: Separating the proposals would unnecessarily complicate the current system.
>
> Lottery system: A straight numeric cap on resolutions could undermine the entire system by opening up ballots to frivolous proposals.

Fourth, and most importantly, I believe that a consensus for reforming the shareholder proposal process can be reached. Any consensus will involve a series of compromises carefully crafted into a package of reforms. By using a survey, you are asking respondents to examine each aspect of the package as a stand-alone piece. For example, although I oppose a lottery system as a one-shot reform, I might accept it as part of a broader package. Such a package was introduced by SEC Commissioner Steven M. H. Wallman last October. He designed the model to tackle two problems with the current system - the "lack of a guiding principle and a heavy reliance on subjective line drawing" by the SEC staff.

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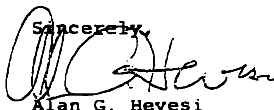
Shortly after Commissioner Wallman unveiled his proposal, the Council of Institutional Investors organized a conference call with a broad group of participants involved in the process. The working group of shareholders and corporations reached an agreement in principle on the alternative model proposed by Commissioner Wallman. In the opinion of the working group, the consensus agreement is substantially superior to the current rule. A draft of the proposed changes is attached. Finally, I should note that this consensus was not easy to achieve; an earlier attempt, chaired by my Deputy Comptroller, was less conclusive partially because we took exactly the type of disaggregated approach taken in the survey. That is not to say that surveys are worthless - they can disclose a great deal of factual information. That is why I am pleased to enclose the survey with parts A and C completed. I have, however, opted to not complete part D, which asks for suggestions for reform, for all the reasons stated above.

I appreciate this opportunity to formally express my views on the shareholder proposal process. Please feel free to call me, or my Deputy Comptroller for Pensions, Jon Lukomnik, if you desire more information.

Sincerely,



Alan G. Hevesi

AGH:sed

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.
May 9, 1997

The Honorable EDWARD J. MARKEY
United States House of Representatives
2133 Rayburn House Office Building
Washington, D.C. 20515-2107

DEAR CONGRESSMAN MARKEY: Thank you for providing me with the opportunity to respond to your questions in connection with the House Subcommittee on Finance and Hazardous Materials' recent authorization hearing.

I look forward to continuing to work with you as the Subcommittee considers the SEC's reauthorization request and other important issues.

Sincerely,

ARTHUR LEVITT
Chairman

Enclosure

ACCOUNTING STANDARDS AND PRACTICES

Question 1: As you know, the Private Securities Litigation Act contained a financial fraud reporting provision, which requires accountants to structure their audits in a manner designed to detect financial fraud, and requires prompt reporting of fraud to a company's board and the SEC. Did this requirement come into play in the Centennial Technologies case? Has it been used in any other investigations or enforcement actions?

Response: The reporting provisions of Section 10A of the Securities Exchange Act (added by the Private Securities Litigation Reform Act), will not apply to Centennial Technologies until the audit of its 1997 financial statements. The Commission has filed an insider trading case arising from this investigation, *SEC v. Pinez*, Litigation Release No. 15258 (February 14, 1997) (see Attachment A), and may pursue other issues also.

The Commission has received filings under new Section 10A reporting possible financial frauds detected by auditors. As with all other information about possible violations, the Commission considers these reports in determining whether to pursue an investigation that may ultimately lead to civil actions or administrative proceedings. A Section 10A letter has been referred to in at least one enforcement action. *See, In the Matter of Merle S. Finkel, CPA*, Exchange Act Release No. 38388 (March 12, 1997) (see Attachment B).

Question 2: As a general matter, what impact do you expect the financial fraud reporting provision to have on the auditing profession?

Response: The reporting requirements in the Act should provide an auditor with additional leverage to influence management of a public company to correct certain illegal acts. Further, the auditor should have more incentive to influence public companies to correct illegal acts because auditors may be subject to administrative action by the Commission for knowingly failing to notify the Commission of a public company's uncorrected illegal act.

Contemporaneously with the implementation of this new reporting provision, the Auditing Standards Board has adopted a new standard entitled, "Consideration of Fraud in a Financial Statement Audit." (see Attachment C) This standard requires the auditor to assess the risk of material misstatements in financial statements due to management fraud and provides categories of fraud risk factors to be considered in the auditor's assessment. This standard should result in the auditor spending more time looking for, analyzing, and documenting indications of fraudulent financial reporting.

Question 3: One concern I have had in recent years has been the threats to the independence of the FASB and the persistent efforts by some in the corporate community or the securities industry to weaken accounting standards. What are you doing to maintain strong accounting standards against this assault? I understand that another anti-FASB campaign is being mounted by those opposed to FASB's proposed accounting standards for derivatives. What is the SEC doing to assure that FASB resists such pressures and adopts a strong accounting standard for these products?

Response: The Commission has expressed its strong commitment to safeguard and strengthen the independence of the FASB and to ensure that the FASB continues to be free of undue influence from special interest groups.

On July 8, 1996, the Commission and the Financial Accounting Foundation (FAF), the parent organization for the FASB that is responsible for selecting FASB mem-

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bers and for funding FASB activities, announced an agreement (see Attachment D) to make changes in the membership of the FAF Board of Trustees to achieve a balance between those who do and those who do not have a special interest in the outcome of accounting standards setting. These changes serve to enhance the FAF, maintain accounting standards set in the private sector, and protect the integrity of U.S. accounting standards.

Practically since its inception, the Commission has looked to the private sector for leadership in setting accounting standards. FASB now provides that leadership. The Commission's role in this process generally has been one of oversight. Nevertheless, the Commission has the authority, and the responsibility, to see that accounting principles followed by registrants serve the interests of investors. Accordingly, we oversee all FASB standard setting projects to assure that the FASB is operating in the public interest and that the results of its work are credible and are the product of an independent and unbiased process.

Question 4: Over the years, we have established self-regulatory organizations for brokers in order to establish codes of appropriate professional conduct for the industry and inspect and examine members to assure compliance with such standards. Should we consider establishing a similar mechanism for the accounting provision, as a supplement to the standards setting role currently performed by the FASB?

Response: A statutory self-regulatory organization to establish codes of conduct for accountants and auditors practicing before the Commission, and to inspect and examine these firms, has been considered from time to time by the Commission and may be reconsidered in the future.

The American Institute of Certified Public Accountants (AICPA) has adopted a Code of Professional Conduct that governs the practice of its 330,000 members. Also, through its SEC Practice Section, the AICPA has established two programs that are designed to ensure that the financial statements of SEC registrants are audited by firms with adequate quality control systems. First, a peer review of each member firm by other accountants is required every three years. Second, litigation against each member firm is reviewed for any implication that the firm's internal quality controls over its accounting and auditing practices may need to be improved. Both programs are overseen by the Public Oversight Board, an independent body, and the Commission staff.

In addition, the Commission promotes proper professional conduct by instituting disciplinary action against individuals and firms that engage in improper professional conduct.

Question 5: Over the years, there have also been calls for "harmonization" of international accounting standards. What is the SEC doing to assure that such harmonization, if it occurs, does not result in a weakening of U.S. GAAP or a global race to the bottom to lower standards?

Response: The International Accounting Standards Committee (IASC) is working to develop a core set of international accounting standards (IASs). These would cover the accounting issues that most enterprises would likely encounter in preparing its financial statements for use in cross-border offerings and listings. The International Organization of Securities Commissions (IOSCO), of which the SEC is a member, worked with the IASC to develop a work plan, scheduled for completion in March 1998, to complete a core set of IASs. IOSCO has stated that if the completed standards are acceptable it would recommend endorsement of IASs for cross-border capital raising and listing purposes in all global markets.

The Commission has stated that there are three key elements to this program and the Commission's acceptance of its results:

- The standards must include a core set of accounting pronouncements that constitutes a comprehensive, generally accepted basis of accounting;
- The standards must be of high quality—they must result in comparability and transparency, and they must provide for full disclosure; and
- The standards must be rigorously interpreted and applied.

In order to enhance the possibility of the IASC achieving an acceptable set of standards, the SEC staff has been engaged in the following activities:

- Commenting on various IASC proposed standards, directly and through IOSCO;
- Attending IASC board meetings and steering committee meetings as IOSCO observers; and
- As part of IOSCO, urging the IASC to establish an interpretive body. The IASC has appointed a standing interpretive committee to facilitate consistent interpretation and application of international standards among IOSCO member nations. The committee held its first meeting in April.

SEC Commissioners and staff have commented that, to be considered acceptable for filings in the U.S., IASs must yield the same quality, in terms of credibility and integrity, as U.S. standards.

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Question 6: One recent press report ("Accountants Increasingly Poach on Brokers' Turf," *Wall Street Journal,* February 12, 1997 at C1) reports that more than 400 accounting firms have formed alliances with securities broker-dealers and mutual fund companies to sell financial products and services. The article indicates that the Commission has concerns about these practices and plans to monitor them closely. Please describe the current federal and state laws and regulations governing accountants' activities in this area. Does the Commission believe these laws and regulations are adequate, or are reforms needed?

Response: The federal securities laws require auditors to be independent from their SEC audit clients, and the Commission's regulations state that performing broker-dealer functions such as recommending securities, soliciting customers, and executing orders will impair an auditor's independence. Also, as noted in the article cited in your question, under state and federal laws and regulations, auditors may not perform other investment services for a contingent fee. More specifically:

- The Commission staff monitors the activities of accountants that serve as auditors of public companies to assure that those auditors are independent from their public company audit clients and to assure that they do not act in the dual capacity of broker-dealer and auditor of the public company.
- In recent years, accounting firms have entered into an increasing number of non-audit services, including those traditionally provided by broker-dealers. The Commission has not objected to firms entering into these service lines. Providing such services *to an audit client* that is a public company could impair the firm's independence, however. Commission staff evaluates these situations as they come to our attention to ascertain whether reforms to existing laws and regulations are needed.

MUTUAL FUND FEES/DISCLOSURE

Question 1: There have been numerous media reports over the last several years to the effect that—notwithstanding the tremendous asset growth in the mutual fund industry—some mutual funds are still not lowering their fees. As you know, some mutual funds have fee structures that take advantage of economies of scale, so that as overall assets under management increase, the fees charged to each individual investor decrease. Many others, however, have not reduced their fees, even though assets under management have grown enormously. Are we doing everything we can to educate investors about mutual fund fee levels and encourage them to compare the fees being charged by various mutual funds?

Response: We are very actively trying to educate investors about mutual fund fee levels and to encourage them to compare fees charged by different mutual funds. We have taken many steps to inform investors about fees including, for example:

- Beginning in 1988, the Commission required all mutual funds to disclose their fees and expenses in a fee table at the beginning of their prospectuses. We understand from focus groups and surveys that investors find the fee table informative and helpful.
- As part of recent proposed rules designed to improve prospectus disclosure, the Commission proposed certain changes to the fee table disclosure designed to make the information more understandable. These are described more fully in response to the next question.
- The Commission has published a brochure about investing in mutual funds. The brochure includes a section on the importance of fees, that has been widely distributed.
- We have emphasized the importance of fees in evaluating mutual fund investments in town meetings and speeches across the country and have sought to encourage the fund industry to take greater initiatives in educating investors about fees.
- Most recently, a task force of several Commission offices, including the Office of Investor Education and Assistance, the Office of Economic Analysis, and the Division of Investment Management, was formed to examine investor literacy on fee issues and to focus on how information about fees could be more effectively communicated to investors.

We have reservations about certain of the data published to date on trends in mutual fund fees. For example, some reports appear not to have taken into account changes in the load structure of mutual funds over time. A 1994 study conducted by the Division of Investment Management found that the average sales charges for funds with front-end loads fell from 8.5% in 1979 to 4.75% in 1992. As a result, the average expense ratio for front-end load funds in many asset size categories tended to be lower in 1992 than in 1979. Commission staff is working to develop better in-

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formation about mutual fund fees as we continue to evaluate how best to educate investors on investing in funds.

Question 2: Recently, the SEC adopted a mutual fund prospectus rule that improves the disclosures being provided to investors regarding fees. Can you explain how these new disclosures work, and how investors use them to compare fees being charged by different funds?

Response: The SEC's recently proposed amendments (The rule was proposed in March, but has not yet been adopted and the comment period ends on June 9) to the prospectus disclosure requirements are intended to focus prospectus disclosure on essential information about a particular fund to assist investors in deciding whether to invest in that fund. The proposed amendments include improvements to the fee table, which has been an important feature of prospectus disclosure since 1988. The fee table is designed to provide clear and uniform information about the fees and expenses associated with an investment in a fund.

The proposed improvements include:

- *Better narrative descriptions of the information provided in the table.* Focus groups conducted for the Commission revealed that some participants had difficulty in understanding the information in the fee table. To help investors use the information, the proposed amendments would require narrative descriptions before the fee table and the "Example" that accompanies the table to state clearly the purpose of the information, i.e., that the table describes the fees and expenses an investor may pay, and that the example is intended to help an investor compare the cost of investing in the fund compared to the cost of investing in other mutual funds.
- *Use of a more typical hypothetical investment in a Fund of $10,000.* The example in the fee table currently discloses the cumulative amount of fund fees and expenses over 1, 3, 5, and 10 years based on a hypothetical investment of $1,000. Fund investors frequently make much larger investments in funds. We proposed to increase the hypothetical investment amount to $10,000 to reflect the typical fund investment and to more closely approximate the amount of fees and expenses that an investor may expect to incur over time.
- *Simplified fee table headings and captions.* The proposed amendments would revise the captions in the fee table to help explain the difference between fees paid directly by shareholders and expenses that are deducted from fund assets. Other changes would standardize and clarify references to certain types of fees that have caused confusion among investors. For example, under the revised form, sales loads would be called sales fees and Rule 12b-1 fees would be called marketing fees. These changes also would help investors to compare fees among funds.

Question 3: Do you think that mutual fund directors are doing everything they should to fulfill faithfully their responsibilities as they are annually approving the fees being charged to investors? Should fund directors be asking harder questions about these fees?

Response: The Investment Company Act of 1940 assigns significant oversight responsibilities to mutual fund directors to act as "watchdogs" for fund shareholders. Inspections of mutual funds have shown that mutual fund directors generally are conscientious and thorough in their evaluation and annual approval of mutual fund investment advisory contracts and, in particular, fee arrangements. In speeches and other public forums, the members of the Commission and Commission staff has actively encouraged fund directors to ask hard questions about mutual fund fees. We also will continue in inspections of mutual funds to focus on the directors' review, consideration, and approval of investment advisory contracts.

U-5 IMMUNITY

Question 1: For years the securities industry has asked for immunity for statements it makes in the Form U-5 regarding the reasons they have terminated their employees. There have been a number of cases in recent years in which securities firms have been successfully sued by employees for having used the U-5 to retaliate against former employees or whistleblowers. Three years ago, the Subcommittee held a hearing on rogue brokers. At that hearing, I ask the SIA to provide me with a list of firms that had been successfully sued by former employees for making truthful statements on the U-5. They promised to provide me with such a list. Three years later, I am still waiting. Please provide me with a listing of all cases the Commission is aware of in the last five years in which a registered broker-dealer was successfully sued by a former employee for disclosing truthful information regarding the reasons for an employee's departure or dismissal.

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Response: Under state law, truth is an absolute defense to a defamation action. As a result, the staff is not aware of any such cases.

Question 2: Provide a second listing of all cases within the last five years in which an employee successfully sued a registered broker-dealer for libel, defamation of character, whistleblower harassment, or retaliation in connection with statements made on the U-5.

Response: Because most claims by registered representatives against broker-dealers are decided in arbitration, there are few reported judicial decisions addressing suits involving libel, defamation of character, whistle-blower harassment, or retaliation in connection with statements made on Form U-5s regarding the reasons for employees' departures or dismissals.

The Commission staff is aware of three recent judicial decisions in which courts have affirmed arbitration awards where the underlying claims consisted of defamation actions brought by registered representatives against broker-dealers for Form U-5 statements. These decisions are:

1. *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704 (7th Cir. 1994); (see Attachment E)
2. *Glennon v. Dean Witter Reynolds, Inc.*, 83 F.3d 132 (6th Cir. 1996); (see Attachment F) and
3. *Eaton Vance Distributors. Inc. v. Ulrich,* 1997 WL 11945 (Fla.App. 2 Dist.) (see Attachment G).

The major SROs that administer arbitration programs may be able to provide additional relevant information regarding the numbers and types of claims brought by employees or former employees against broker-dealers in arbitration. I will ask the Commission staff to forward your request to the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. and ask that they respond directly to you.

Question 3: In light of the responsibilities of the SROs to assure compliance by member firms with SRO rules and the requirements of federal securities laws, are you confident the SROs are doing everything they should to make certain that firms are disclosing adverse information about brokers who engage in illegal or abusive activities on the Form U-5? Do the SROs examine their members to assure compliance in this area? Do they take action against abuses by member firms in this area—both those involving failure to disclose adverse information or misuse of the U-5 to harass, retaliate against, or defame former employees? Has the SEC staff examined the adequacy and efficacy of SRO efforts in this area? Has the SEC staff included a review of securities firms' compliance with the U-5 requirements in its own examinations and inspections of such firms?

Response:

- SROs routinely review the circumstances surrounding the filing of Form U-5s that indicate employees either were permitted to resign, were discharged, or were terminated non-voluntarily. SROs also inquire into the circumstances surrounding a firm's termination of a broker in the context of their general examination programs.
- The filing by a firm of a Form U-5 for the purpose of harassing, retaliating against, or defaming a former employee is likely to come to an SRO's attention in one of two ways. First, the former employee may file a complaint directly with the SRO regarding such a Form U-5. Second, the employee may commence an arbitration action against the firm. In this case, the arbitrators would refer the matter to the SRO's enforcement department if they thought the conduct complained of was sufficiently egregious that a regulatory body should review the matter from a regulatory perspective.[1]
- The Commission examines securities firms' compliance with the Form U-5 disclosure requirements as part of its general sales practice review of brokers and oversees the SROs' efforts in this area through its general review of SRO examination and enforcement programs.

Question 4: There have been reports that the Commission is considering granting either full or qualified immunity to securities firms for statements made on the U-5. What is the difference between "full" and "qualified" immunity in this context? What would be the impact of such a change on those employed in the industry? Would whistleblowers be less likely to come forward due to fears that adverse information would be placed into their U-5 in retaliation?

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[1] Pursuant to Section 10105 of the NASD Code of Arbitration Procedure, if an arbitrator has reason to believe there has been a violation of the NASD's rules or of the federal securities laws, "the arbitrator may initiate a referral of the matter to the Association for disciplinary investigation." The NYSE has a similar instruction to its arbitrators in its training materials.

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Response: Under the law of most states, broker-dealers are provided qualified immunity for Form U-5 disclosures. That means, as one court has stated, that a firm is protected from a defamation claim by a registered representative in connection with its statements on Form U-5 unless it "knows or is reckless in failing to discover that it is defaming [a registered representative] falsely." *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704, 708 (7th Cir. 1994).

In contrast, New York courts apply a standard of absolute immunity for Form U-5 disclosures. This means that a broker-dealer employer is protected from defamation liability regardless of whether the statements made on the Form U-5 are true or false. These courts reason that statements required by Form U-5 are made in connection with a quasi-judicial proceeding and, therefore, are absolutely privileged.

The Commission has not formally considered the immunity issue. The NASD Regulation, Inc. has formed a working group, comprised of representatives from NASDR, the states, the Securities Industry Association, the New York Stock Exchange, member firms of the NASD, and the public. This group apparently is making progress in efforts to reconcile the various concerns raised by different levels of immunity. The Commission is keenly aware of the competing concerns in this area and is committed to ensuring that any level of immunity that is established not permit intentional defamation or chill potential whistleblowers who fear retaliation.

Additional information may be provided.

OTC DERIVATIVES

Question 1: The SEC currently regulates certain OTC options. Do you think these products should continue to be regulated? Why or why not?

Response: Yes. The Commission regulates OTC options that are securities and believes that these products should continue to be regulated as such. The provisions of the federal securities laws, including vital antifraud measures and other provisions that preserve market integrity, apply to all securities, regardless of whether they are traded on an exchange or OTC. OTC stock and stock index options are used by many institutional participants. In light of their use and potential impact on the underlying markets, they should continue to be regulated as securities.

Question 2: Do you feel that the SEC currently has sufficient information on equity swaps to deal with any problems that might arise in the primary markets as a result of these products? Would your answer be the same if equity swaps became more common, as might be expected to occur if the statutory exemption in S. 275 became law?

Response: At the present time, equity swaps are effected through privately negotiated OTC transactions between institutional counterparties. This private market is not yet well-developed, and it is impossible to predict whether and how the market for equity swaps will expand if S. 275 or other bills proposing to amend the Commodity Exchange Act (CEA) were to be enacted. Equity swaps are hedged in public, cash securities markets that are subject to Commission regulation. At this time, it appears that the Commission's existing authority to police the cash securities markets provides it with sufficient authority to detect or prevent fraud and manipulation, and to address any market irregularities that may arise in response to cash market trading by equity swap market participants.

Question 3: If the statutory exemption to the CEA in S. 275 becomes law, will the SEC have the ability to address any violations of the federal securities laws that involve equity swaps? How could the SEC's authority in this area be made clearer?

Response: The Commission has authority to address violations of the federal securities laws in connection with the purchase and sale of *securities*. There is debate regarding the legal status of equity swaps under the federal securities laws. Some argue that equity swaps are not securities, but the Commission has not taken a position on this issue. The market for these products is in its infancy, and circumstances can change. In the event abuses arise in this market, the Commission would evaluate its existing authority to address these abuses, and would seek any additional authority, as needed.

Question 4: During the Subcommittee's hearing, Chairman Levitt stated that the SEC currently has no plans to regulate OTC derivatives transactions, even if these transactions are excluded from the Commodity Exchange Act. Would the SEC's plans change if equity swaps proliferated and there was some evidence that they were adversely affecting the primary markets for equities? Are there any other circumstances in which the SEC would take action to impose some regulatory scheme on equity swaps? Is the SEC, for example, at all concerned about the lack of transparency in this market, the absence of margin requirements, circuit breakers, intermarket information sharing arrangements?

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Response: At present, the limited development of equity swaps has not presented the Commission with the need to address these issues. If market events and circumstances were to change, the Commission would closely examine whether direct regulatory involvement is warranted for equity swaps to the extent they are securities. Of course, the Commission could address ramifications for the cash market of a growing equity swap market threugh measures directly addressing the cash markets.

Question 5: Is the SEC at all concerned about the potential for insider trading using OTC swaps?

Response: To date, we have no evidence that OTC equity swaps have been used for insider trading purposes. We continue to monitor the development of the equity swaps market and would take appropriate regulatory and enforcement measures if abuses were to develop in this area.

Question 6: In 1987, we learned from the Brady Commission report and other studies that the market for stocks, stock options, and stock index futures operates as a single market. Are equity swaps and other OTC derivatives part of this unitary, interdependent market? If so, should we be concerned that growth in the equity swaps market could have an adverse effect on other parts of the markets for securities? What role should the SEC play in monitoring and minimizing any adverse effects?

Response: In a broad sense, OTC derivatives are linked to the stock, options, and futures markets. The major OTC derivatives dealers and users also participate in these markets and often use trading or hedging strategies for OTC derivatives that involve the cash, option, and futures markets. To date, however, equity swaps have not had a significant impact on the stock, options, or futures markets due to the limited activity in equity swaps. As principal regulator of the equities markets, the Commission closely monitors the development of these products and their effects on such markets. If equity swaps were to cause any adverse effects on the equities markets, the Commission would take appropriate measures regarding those markets to counter these effects.

Question 7: In 1994, the Subcommittee held a number of hearings on the OTC derivatives market, including an examination of the May 1994 General Accounting Office report on derivatives (Financial Derivatives: Actions Needed to Protect the Financial System, (GAO/GGD-94-133, May 18, 1994). One of the recommendations of the GAO was that the SEC ensure that its registrants that are major dealers and end-users of complex derivative products establish and implement corporate requirements for independent, knowledgeable audit committees and public reporting on internal controls. A more recent GAO report submitted to the Subcommittee (Financial Derivatives: Actions Taken or Proposed Since 1994 GAO/GGD/AIMD-97-8), November 1, 1996) reports that the SEC has failed to implement this recommendation, or alternatives suggested by the GAO. Please explain the justification for this.

Response: As the Commission testified in May 1994, the Commission believes that, at this time, investors will be better served by enhanced accounting for, and disclosure of, derivatives and market risk management activities than by implementing the GAO recommendations.

After intense study and discussions with the business community, the accounting profession, the securities industry, and others, the Commission recently adopted disclosure rules that are an important step in bringing derivatives and risk management activities into the view of investors. The Financial Accounting Standards Board also is engaged in a major project that will address and clarify the accounting implications of derivatives activities.

Question 8: The November 1996 GAO report also indicates that SEC and CFTC oversight over OTC derivatives dealers has improved, but that regulatory gaps continue to persist in this area. Please respond to the following questions regarding the DPG:

A) What is the Commission's view as to the overall success or failure of the DPG in improving oversight over OTC derivatives dealers affiliated with securities firms? What lessons has the SEC learned from this process?

Response: The establishment of the Derivatives Policy Group (DPG) has been successful in improving our supervisory oversight and understanding of the unregistered OTC derivatives dealers that are affiliates of the major U.S securities firms.

Based on the analysis to date, the Commission staff has observed the following:

- Although the Commission has no statutory authority to require the information in the DPG Reports directly from the unregulated entity, the firms have been cooperative in addressing concerns and questions regarding the information in the reports.
- There does not appear to be a standardized way of thinking about risk among the firms reporting, as each firm has differing portfolios and risk profiles and as

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a result variation exists in the Value at Risk ("VAR") models (also called Capital at Risk models). The VAR amounts reported by these OTC derivatives dealers appear to be low in relation to the notional value and replacement cost of the portfolios and therefore may be unreliable as a capital standard. Some firms place more reliance on VAR than others as a market risk management tool.

- External auditors have been reluctant to issue audit opinions on mathematical models because auditing standards do not appear to address this issue. The lack of a standardized model may create additional auditing difficulties.

Question: B) How has the SEC utilized information obtained from DPG member firms? Based on its experiences to date, what (if any) improvements or modifications in the DPG framework does the SEC believe necessary?

Response: The Commission staff primarily has used the information provided by the five reporting DPG member firms to develop a view of the OTC derivatives activities of each firm and a composite view of the OTC derivatives markets represented by the combined activities of the member firms. Changes in activity are tracked on a quarterly basis.

The information has enabled the Commission staff to understand the magnitude of such activities and the nature and extent of the associated risks. Measures of market risk and credit risks are provided with concentrations of credit risk provided both geographically and by counterparty.

The VAR measure is used to quantify market risk and has provided a basis for the Commission staff to use in its study of the possible use of VAR models for assessing capital adequacy.

The information provided regarding management controls allows the Commission staff to assess the effectiveness of the control systems in place at the member firms and allows for open discussion regarding such systems between the Commission staff and the member firms.

Commission staff currently is in discussion with the DPG member firms regarding the following improvements or modifications:

- Examine management controls and monitor capital adequacy at the holding company level.
- Report names of significant counterparties instead of codes regarding counterparty credit risk.
- Provide further information on how the positions are hedged.
- Consider including additional firms in DPG reporting that have significant derivatives activities.

Question: C) What is the SEC's response to GAO findings regarding the gaps in the voluntary framework the SEC and the CFTC established through the Derivatives Policy Working Group. What steps is the SEC taking to close these gaps? If the SEC does not concur with the GAO's recommendations for additional changes, please provide an explanation of the basis for the Commission's disagreement.

Response: These items discussed on page 12 of the November 1996 GAO report are not regulatory gaps. The GAO comments result primarily from the absence of legal/statutory authority to effect regulatory oversight of the OTC derivative dealers that are affiliates of U.S. registered broker/dealers. The voluntary framework was established because of this lack of formal statutory authority. Noted below, in turn, are the subjects of the GAO's other findings, followed in each case by the requested explanation.

- Voluntary compliance—Although the Commission has no statutory authority to require the information in the DPG reports directly, the concept of supervision without regulation has worked well thus far, primarily due to the cooperation of the firms and the willingness to respond to the Commission's suggestions and comments.
- Limited to five firms—The OTC derivatives activities of the five reporting firms account for approximately 90% of the unregulated OTC derivatives notional/contract value for all U.S. securities derivative dealers not affiliated with bank holding companies or insurance companies. The inclusion of additional firms that would cover the remaining 10% of the activity would greatly increase the amount of information to be analyzed by the staff without providing any additional value to the process and would be cost prohibitive to those smaller firms. However, additional firms with significant derivatives activities may be included in DPG reporting.
- No explicit authority to enforce operational changes, conduct examinations, or impose capital requirements—Having certain statutory oversight authority over holding companies of registered broker/dealers likely would be useful, however, the Commission has not proposed establishing capital requirements at the holding company level.

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- Insurance holding companies that have OTC derivatives dealers as subsidiaries—With regard to insurance companies that have affiliated entities that are OTC derivative dealers, extending some form of oversight to these entities does not appear to be part of the Commission's jurisdiction.

Question: D) Please explain why the securities firm CS First Boston is not submitting information to the SEC or CFTC as part of the DPG. Does the SEC and the CFTC receive *exactly* the same information in the copies it receives of the company's filings with the Bank of England as the other OTC dealers file under the DPG framework? If not, please provide side-by-side comparisons of the types of information provided and explain why this firm is not providing the same information as other firms.

Response: The affiliated entity of CS First Boston that is a dealer in OTC derivatives is regulated by the Bank of England. As such, the entity is exempt from reporting under the DPG voluntary framework. The report this entity furnishes to the Bank of England is also received by the SEC and contains information similar to the information provided under the DPG framework, except that the Bank of England does not include a VAR computation or stress test data.

Question: E) GAO reports that the five reporting DPG firms account for 90 percent of the total derivatives notional/contract value of all U.S. securities derivatives dealers in 1995. Please provide a list of the firms that account for the remaining 10 percent. Why aren't these firms also parties to the DPG framework?

Response: The remaining 10% of the overall dealer activity in OTC derivatives is spread out among a substantial number of firms. Of these, the approximately 220 largest firms have the bulk of the remaining OTC derivative activities. These 220 firms are reviewed quarterly for significant amounts of derivatives activity under the SEC's Risk Assessment Program. Based on the ongoing review and analysis of these firms, the amount of activity in these firms individually, or in the aggregate, is immaterial.

For example, the five reporting DPG member firms had the following aggregate notional amounts of off-balance sheet derivative instruments at their respective 1995 fiscal year end:

[In Billions]

Firm Name	Notional Amount
Salomon, Inc	$1,659
Merrill Lynch & Co	1,610
Lehman Brothers Holdings, Inc	1,209
The Goldman Sachs Group, LP	1,091
Morgan Stanley Group, Inc	985
Total DPG Firms	$6,554

The next five U.S. firms' combined notional amounts of off-balance sheet derivative instruments represent only 4.2% of the aggregate notional amounts of off-balance sheet derivative instruments of the ten firms taken as a whole:

[In Billions]

Firm Name	Notional Amount
The Bear Stearns Company, Inc	$128
Smith Barney Holdings, Inc	48
PaineWebber Group, Inc	41
Donaldson, Lufkin & Jenrette, Inc	39
Prudential Securities, Inc	28
Total	$284

Also, the cost to these smaller firms to comply with the framework would be significant. The DPG is a group composed of the largest dealers in OTC derivatives in the U.S. that are affiliates of the five largest U.S. broker/dealers that are not subsidiaries of bank holding companies. These entities each spent several million dollars to establish a framework, to comply with the DPG voluntary reporting.

Question: F) In light of the shortcomings inherent in a voluntary reporting approach, would the SEC support legislation to establish formally SEC authority over derivatives dealers affiliated with securities firms or insurance companies?

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Response: At this time, the Commission is not seeking additional legislation. The Commission currently receives information about affiliates in several different ways. In addition to the information the Commission receives pursuant to the voluntary reporting approach of the DPG, the Commission's risk assessment recordkeeping and reporting rules provide the Commission with an overview, on a periodic basis, of the financial and securities activities of the affiliates that are likely to have a material impact on a broker-dealer's financial condition. Broker-dealers also are required to file with the Commission records concerning their policies, procedures, and systems for monitoring and controlling financial and operational risks resulting from the activities of their affiliates. In the event the Commission were to determine that it required additional authority over derivatives dealers in the future, the Commission would seek additional authority as needed.

Question 9: Some OTC derivatives dealers have argued that legal uncertainty is the concern motivating their desire for amendments to the CEA. If this is the case, why wouldn't a preferable solution to such concerns be to include a provision in the CEA that nonenforceability of contracts is not permitted as a means of enforcing the CEA?

Response: It is important to provide the market with enhanced legal certainty for privately negotiated OTC swaps and other derivative transactions effected between large institutional counterparties. The OTC derivatives marketplace involves privately negotiated contracts between institutional customers that warrant a different framework and level of regulation from organized public marketplaces. The Commission has not yet considered the possible effects of including a provision in the CEA that nonenforceability of contracts would not be permitted as a means of enforcing the CEA. However, there are general concerns about requiring parties to perform under contracts that violate the CEA. In this regard, Section 29 of the Exchange Act, which has been interpreted to mean that contracts made in violation of the Exchange Act are voidable, has proved useful to investors and the Commission.

Question 10: I am greatly disturbed by recent reports that an effort may be underway to undermine the SEC's recent rule on improving derivatives disclosures, which I believe is a necessary antidote to the inadequacies revealed in connection with Bankers Trust, Proctor & Gamble, Gibson Greeting, and other recent cases. Does the SEC intend to resist any Congressional efforts to overturn its recently adopted rules? If so, has the SEC communicated its views on this matter to the relevant Committees in Congress and to the Administration?

Response: I recently addressed issues relating to the derivatives disclosure rules in correspondence with Chairman Oxley of the House Subcommittee on Finance and Hazardous Materials of the House Commerce Committee and Chairman Phil Gramm of the Senate Subcommittee on Securities of the Senate Banking Committee. A copy of the relevant correspondence is attached (see Attachment H).

NSMIA AND COST-BENEFIT ANALYSIS

Question 1: The Commerce Committee staff memorandum prepared in conjunction with the Subcommittee's hearing states that "according to reports from the General Accounting Office regarding several recent rulemakings by the SEC, the SEC has indicated it believes there is no statutory mandate that it prepare a cost-benefit analysis of any rule." Is this an accurate reflection of the Commission's position on this matter?

Response: The issue of how the Commission has incorporated the role of economic analysis into its rulemaking process was addressed in my recent letter to Chairman Bliley on the subject. The relevant correspondence is attached for your information (see Attachment I).

Question 2: In undertaking rulemakings based [on] the public interest standard in the federal securities laws, hasn't the Commission always considered impacts on competition, efficiency, and capital formation? Aren't there other provisions of the federal securities laws (i.e. Section 11A of the Exchange Act) which have required the SEC to consider impacts on competition? Isn't it also clear from the legislation history of NSMIA that Congress intended the SEC's investor protection mission to remain paramount?

Response: As the Commission testified when Congress was considering the National Securities Markets Improvement Act (NSMIA), the Commission has long considered efficiency, competition, and capital formation among the factors relevant to its determination whether a proposed rule is in the public interest.

The House Committee Report relating to NSMIA states that "matters relating to efficiency, competition and capital formation are only part of the public interest determination, which also includes, among other things, consideration of the protection

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of investors. For 62 years, the foremost mission of the Commission has been investor protection, and this section does not alter the Commission's mission."

As you note, certain provisions of the Exchange Act, such as Section 23(a), require the Commission to make an explicit finding regarding whether a proposed rule under the Exchange Act "imposes a burden on competition not necessary or appropriate in furtherance of the purposes of this title."

Question 3: In considering impacts on capital formation, does the SEC intend to consider whether a loss of investor confidence in the fairness and integrity of the markets might impair the capital formation process? If not, why not?

Response: Yes. The possible loss of investor confidence in the fairness and integrity of the securities market is one factor the Commission may consider in assessing a proposed rule's possible impact on capital formation.

YIELD BURNING

Question 1: Recent press reports (e.g., "SEC Widens Muni-Bond Scrutiny: Yield Burning Costs Worry Local Officials," Wall Street Journal, February 20, 1997, at C1) indicate that the SEC is ratcheting up its scrutiny of so-called "yield burning" abuses in the municipal securities market. Please describe the activities commonly known as "yield burning" and what concerns these activities raise under the federal securities laws.

Response: Virtually every municipal bond offering requires the temporary reinvestment of some portion of the proceeds of that offering for some period of time. For tax-exempt offerings, the Internal Revenue Code (the Code) limits the return, or yield, that an issuer may receive on the reinvestment of the proceeds of an offering. The restrictions on reinvestment yield contained in the Code and the implementing regulations are complex, and detailed questions concerning their interpretation and application are best directed to the IRS. Basically, the IRS arbitrage rules are designed to restrict the receipt of arbitrage: profit obtained from borrowing money at low tax-exempt rates and reinvesting those funds in higher yielding securities. As a consequence of the IRS arbitrage rules, the reinvestment of the proceeds from a tax-exempt bond offering generally is either yield restricted or subject to an obligation on the part of the issuer (known as rebate) to pay any arbitrage profit to the U.S. Treasury.

An indirect, and unintended, result of the arbitrage rules is to provide an opportunity for the seller of a security used for reinvestment to depress artificially the yield on the security by raising the sales price, which in effect transfers the arbitrage profit to the seller. This is what is known as "yield burning." The tax consequences of arbitrage profit are the same whether it is received by the issuer of municipal securities or by the seller of reinvestment securities. If the IRS determines that arbitrage profit was earned on the reinvestment of the proceeds from a municipal bond offering, and that profit is not returned to the U.S. Treasury, then the municipal bonds will be deemed "arbitrage bonds." For bondholders such a determination has grave consequences—interest on arbitrage bonds is not exempt from federal income tax.

In order to eliminate yield burning, the IRS generally requires that an issuer purchase securities for yield restricted accounts at fair market value, as defined by the IRS. If an issuer is unable to purchase securities at fair market value without violating the applicable yield restriction, it may as an alternative purchase special illiquid treasury obligations with below market interest rates known as State or Local Government Series (SLGS) from the Bureau of Public Debt. Thus, one consequence of yield burning is to defraud the federal government, because the seller of reinvestment securities, rather than the U.S. Treasury, retains the arbitrage profit.

Many of the issues surrounding yield burning, such as the applicable arbitrage limits and the definition of fair market value, are exclusively within the jurisdiction of the IRS. However, yield burning may also involve violations of the antifraud provisions of the federal securities laws. If, for instance, treasury securities used for reinvestment of municipal bond proceeds are sold at greater than fair market value, the seller may have violated the antifraud provisions by charging a fraudulently excessive mark-up on those securities. Sellers of securities used for reinvestment frequently provide explicit representations that the securities were sold at fair market value. False representations can violate the antifraud provisions. Finally, if yield burning occurred, investors in the municipal bond offering may have been defrauded by the failure to disclose material facts concerning the purchase price of the reinvestment securities as well as the associated risk that the municipal bonds could be found to be arbitrage bonds, and therefore lose their tax exemption.

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Question 2: Please list all SEC or SRO enforcement actions brought for yield burning abuses during the last five years and summarize the current status of such actions.

Response: The Commission has never brought an enforcement action that specifically charged an individual or an entity with selling a security for use in a yield-restricted reinvestment account at greater than fair market value. We are not aware of any SRO enforcement actions that include such charges.

In two enforcement actions filed in 1995, the Commission alleged that an underwriter of municipal bonds received undisclosed commissions and other payments from sellers of securities used for reinvestment. The enforcement actions charged, among other things, that the payments created an undisclosed risk to the tax-exempt status of the bonds, and that in failing to disclose that risk, the underwriter and three of its officers defrauded bondholders. The firm settled the Commission charges, and paid a total of $1.4 million in disgorgement, prejudgment interest, and a penalty. *Securities and Exchange Commission v. Stifel, Nicolaus and Company, Inc.,* (W.D. Okla.), Litigation Release No. 14587 (August 3, 1995) (see Attachment J). The action against the individuals is pending in United States District Court for the Western District of Oklahoma. *Securities and Exchange Commission v. Robert M. Cochran, Michael B. Garrett and Randall W. Nelson,* (W.D. Okla.), Litigation Release No. 14644 (September 20, 1995) (See Attachment K). In a related criminal prosecution, Robert Cochran was convicted on federal criminal charges in May 1996. *United States v. Robert M. Cochran,* CR-95-128-T (W.D. Ok.). That conviction was recently overturned by the United States Court of Appeals for the Tenth Circuit. *United States v. Robert M. Cochran,* 109 F.3d 660 (10th Cir. 1997).

Question 3: Press reports indicate that the SEC may also be looking at the adequacy of NASD regulatory oversight of yield burning (see, "NASD Launches Its Own Yield Burning Investigation," Bond Buyer, February 21, 1997, at 1). Has the SEC staff conducted reviews, examinations, or other assessments of the adequacy of NASD regulatory scrutiny of its members activities in this area? If so, has it reached any findings or conclusions (and if so, what are they)?

Response: The NASD routinely examines firms to determine, among other things, whether mark-ups charged by a firm are excessive. From a review of NASD examination guidelines, it appears that the NASD does not routinely conduct specific reviews to determine whether they have sold a security for use in a yield-restricted reinvestment account at a greater than fair market value. Commission staff recently met with the NASD to discuss coordination of our respective efforts and additional meetings are scheduled in the near future.

Question 4: I understand that under a recent IRS ruling, state and local governments that are the subject of yield burning abuses either may have to pay additional funds to the IRS or risk having their tax-free bonds declared taxable. What is the SEC doing to coordinate its yield-burning enforcement activities with those of the IRS? Does the SEC promptly inform state or local governments that may have been the victims of yield burning abuses of the existence of an investigation or inquiry, so that they can take appropriate steps to address the tax consequences?

Response: The reference to a "recent ruling" appears to refer to IRS Revenue Procedure 96-41, released last year. Revenue Procedure 96-41 outlines a voluntary procedure for issuers to enter into a settlement with the IRS related to arbitrage profits earned on securities purchased for advance refunding offerings. That revenue procedure does not affect the longstanding position of the IRS that if a municipal securities offering is not in compliance with the requirements of the Internal Revenue Code, and the issuer will not or cannot bring the offering into compliance, the interest on the municipal security is no longer exempt from taxation. *See, e.g.,Harbor Bancorp & Subsidiaries v. Commissioner,* 105 T.C. 19 (1995).

Since 1993, staff members of the Division of Enforcement have met periodically with IRS staff, at both the national and regional level, to share information concerning our respective enforcement efforts in the municipal securities market. For the most part, these meetings have dealt with general policy and legal issues. From our perspective, these meetings have been useful.

The ability to coordinate respective enforcement efforts concerning specific transactions is limited. There are few restrictions on information that the Commission can provide the IRS pursuant to a grant of access, and where appropriate, we have referred matters to the IRS. On the other hand, because of the requirements of Section 6103 of the Internal Revenue Code [26 U.S.C. §6103], the ability of the IRS to discuss specific transactions with us is limited severely. Under Section 6103, the IRS is prohibited from disclosing taxpayer return information to another government agency absent a court order or a waiver by the taxpayer. "Taxpayer return information" is defined to include tax returns and related information furnished to the IRS by or on behalf of the taxpayer. The IRS takes the position that information

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collected or received by the IRS relating to compliance with the tax-exempt bond provisions of the Code involves the liability or potential liability of specific persons, and is therefore taxpayer return information. Given this statutory limitation on the ability of the IRS to share information with the Commission, effective coordination of individual investigations is difficult.

The Commission has no specific policy concerning notification to issuers about allegations of yield burning. As discussed above, it is for the IRS to determine whether there will be tax consequences of arbitrage profit earned by a seller of securities used for reinvestment in a municipal bond offering. Because of Section 6103 of the Code, discussed above, absent special circumstances, the Commission generally is not in a position to know whether the IRS is examining a particular transaction for yield burning or whether the IRS may conclude that there has been a violation of the arbitrage regulations. However, in any investigation conducted by the Commission that involves allegations of yield burning and fraudulently excessive mark-ups, the Commission typically will seek information from all participants to the transaction, including the issuer of the municipal bonds. Consequently, issuers may become aware of those allegations as a result of a Commission investigation.

INVESTMENT ADVISERS

Question 1: I am pleased to see that the Commission has moved more aggressively against soft dollar abuses, which have been of great concern to the Subcommittee for a number of years, and look forward to receiving a copy of the report Representative Dingell requested on the Commission's findings and conclusions in this area. Please explain why, in light of these ongoing investigations, the SEC reportedly has withdrawn its long-pending rulemaking on enhancing soft dollar disclosure. Has the Commission or the staff changed its position on the desirability of enhancing soft dollar disclosure, or is it simply afraid to move forward in light of industry opposition?

Response: Under existing Commission rules, clients receive general disclosure regarding the soft dollar policies of their advisers. In February 1995, the Commission proposed to require that advisers provide annual reports setting out for their clients quantitative data about client brokerage costs and adviser soft dollar benefits. The Commission received 75 comment letters, only one of which supported the proposal. Moreover, only one institutional investor commented on the proposal, and that commenter opposed the rule, stating that the information contemplated by the annual report could be obtained, upon request, from its advisers. On the basis of the comments it received, the Division of Investment Management concluded that most advisory clients probably would not be interested in the information in the annual report, as proposed. The Division also was concerned that the public disclosure of brokerage information could competitively harm advisers and, indirectly, their clients. In commenting on the rule, some advisers suggested, for example, that a broker-dealer might use the information in the reports to require advisers to allocate a certain percentage of their client trades to the broker-dealer in order to receive sought-after allocations of new offerings. For all of these reasons, the Division has not recommended that the proposal be adopted.

Question 2: For some time, the SEC has had pending a proposed suitability rule for investment advisers. I was assured several years ago that this rule would be adopted promptly, and that there was therefore no need for Congress to legislate on this matter. Why hasn't the Commission moved forward in this area? When can we expect final action on an investment advisers suitability rule?

Response: In March 1994, the Commission proposed to codify its long-standing interpretation that investment advisers have an obligation to give only suitable advice to their clients. Commenters generally were supportive of the rule. Adoption of the rule was put aside, however, in light of other priorities and the resolution of significant ongoing debates as to the proper scope of broker-dealer suitability obligations. The rule has not been withdrawn. It is important to note that failure to adopt the rule does not diminish in any way the obligation of advisers to render suitable advice to their clients, nor does it diminish the enforceability of that obligation under the anti-fraud provisions of the Advisers Act.

PROXY MATERIALS

Question 1: I understand that the NYSE has proposed a new fee structure for mailing of proxy materials which differs significantly from previous fee structures. Some institutional investors reportedly have complained that the new fee structure will significantly increase the fees collected by the intermediaries involved in processing proxy materials. What is the justification for allowing an increase in these fees?

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Response: Under the Commission's proxy rules, issuers are required to pay the "reasonable expenses" of record holders and respondent banks for forwarding proxy materials to beneficial owners. Consequently, intermediaries, who simply pass their costs along, now have little incentive to keep these costs low. Issuers have input in determining or limiting these costs only through participation in a NYSE committee. The NYSE sets reasonable rates for the reimbursement of member organizations. The current proxy rules' structure raises concerns because of the lack of incentives for record holders and their intermediaries to minimize costs to issuers because issuers have no real choice but to pay the designated fees. The Commission staff will re-examine whether the overall system for imposing on issuers the costs of dissemination should be changed to allow market forces and competition to operate in minimizing costs while encouraging dissemination of the materials in the most efficient manner. In the process, the Commission staff will re-examine whether Commission proxy rules should be changed. At present, the NYSE temporarily has amended its fee structure for one year.

The amended NYSE fee structure overall should reduce costs for many issuers as compared to the old NYSE fee structure. There may be some increases for small issuers, but the additional cost may be partially offset by the lower basic rates and lower expenses.

The new fee structure contains a nominee fee for intermediaries that provide coordination for a series of functions across a multitude of nominees. Based on the information provided by the NYSE and the supportive comment letters, the fee appears to constitute reasonable compensation for the services provided by an intermediary and could produce savings for issuers in the long term.

Question: Why and how does it serve the interests of investors for such a fee increase to occur?

Response: The new fees should provide incentives for intermediaries to develop technologically innovative ways to communicate with issuers and to lower costs overall.

Question: What action has the SEC taken on this matter?

Response: On March 14, 1997, the Commission approved the NYSE's proposed fee structure for a one-year pilot. The Commission will review the effect of the fee structure.

The NYSE has committed to an independent audit, at the conclusion of the 1997 proxy season. The audit would assess the reasonableness of the new fee structure.

The one-year pilot and the audit should provide the Commission with the information necessary to determine whether the fee structure needs to be revised.

Question: Has the SEC obtained formal comment from the public on whether the proposed fee increases are just and reasonable? If not, why not?

Response: Yes. The Commission received a total of 39 comment letters on the NYSE's proposal. A substantial majority of the letters supported the proposal. Many commenters believed that the proposal would provide incentives to the industry to continue to explore and develop new technologies as described above. Several commenters, however, had concerns about certain aspects of the proposed fee structure, such as the nominal fee for intermediaries.

DISCLOSURE

Question 1: The University of Michigan recently released a study of trading that occurs during conference calls between company management and large investors. Apparently, during some of these calls, investors may begin trading based on information that has not been disclosed to anyone other than those participating in the call (see, E.S. Browning, "Trading Picks Up During Conference Calls, Evidently Leaving Small Investors on Hold," Wall Street Journal, March 6, 1997, at C2). Does the SEC have any concerns about this practice, and its possible adverse impact on small investors? If so, what actions does the Commission plan to take to address this matter?

Response: The Commission encourages prompt public dissemination of corporate information. The selective disclosure of corporate information regarding a specific issuer can raise a variety of concerns.

Corporate information is disseminated to the public through forms of media that have a variety of different sources and recipients. The amount of information currently available directly to investors is quite substantial. Television, radio, wire services, newspapers, magazines, personal computers, FAX machines, on-line services, and the internet saturate the investing public with a continuous flow of public information. Although methods for delivering corporate information are expanding constantly, it must be recognized that few, if any, corporate disclosures can be disseminated to all market participants simultaneously. For example, even postings on

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the internet (which the Commission has encouraged) reach only those persons who have facilities to receive the information. Therefore, companies should make appropriate efforts to disclose the information in as broad a manner as possible.

An important issue from the standpoint of the federal securities laws is whether material nonpublic information is disclosed. This can raise insider trading concerns which the Commission vigorously pursues. Each year, the Commission institutes a significant number of enforcement proceedings for misuse of material nonpublic information in violation of the antifraud provisions of the Exchange Act.

In addition, Section 15(f) of the Exchange Act creates a specific requirement for broker-dealers to maintain procedures designed to prevent the misuse of material nonpublic information, commonly referred to as Chinese Walls or information barriers. Broker-dealer information barriers include policies and procedures, as well as physical barriers, designed to prevent the improper dissemination of information from one division of a multi-service firm (such as the research department) to another, and trading procedures and reviews designed to prevent and detect illegal trading. *The Wall Street Journal* article cited in your letter refers to a recent enforcement action in which the Commission accepted the settlement offer of Fox-Pitt, Kelton, Inc., a registered broker-dealer, for allegedly violating Section 15(f). (See *In the Matter of Fox-Pitt, Kelton, Inc.*, Exchange Act Release No. 37940 (November 12, 1996) (see Attachment L). That matter involved analysts at Fox-Pitt who received material nonpublic information from an issuer during a conference call placed to securities analysts at brokerage firms; one analyst and salespersons at Fox-Pitt traded in the issuer's stock before disseminating the information to the public. The settlement required Fox-Pitt to retain an independent counsel to conduct a comprehensive review of the firm's policies, procedures and practices to prevent the misuse of material nonpublic information and for it to adopt the procedures and the system for applying those procedures recommended by the independent counsel.

Commission staff currently is reviewing the study released by the University of Michigan regarding the effect of conference calls on trading. If the study indicates that information may be disseminated in violation of the securities laws during conference calls, the Commission will consider an appropriate cause of action.

Question 2: The aforementioned press article reports that the SEC "has rarely tried to discipline investors for trading during conference calls, but it has happened." Please provide a listing of all pending or completed enforcement actions involving such abuses during the last five years.

Response: The *Wall Street Journal* article discusses possible trading abuses associated with selective disclosure of information to a limited number of analysts or investors. Trading abuses in any form are of concern to the Commission. Leads pointing to such violations—as with other violations of the federal securities laws—are pursued to the extent of the Commission's capabilities.

In the cease and desist proceedings described in the article, the case involving Fox-Pitt, Kelton, Inc. discussed above, the firm was sanctioned for its lack of procedures reasonably designed to prevent the misuse of material non-public information, and not for the underlying trading. The staff is not aware of other cases in the last five years that specifically involved trading during conference calls.

In somewhat similar cases where selective disclosures have resulted in abuses (although not in connection with conference calls), the Commission also has taken action. In *SEC v. Phillip J. Stevens,* Litigation, Release No. 12813 (March 19, 1991) (see Attachment M), for example, the Commission alleged that the defendant, the former CEO and chairman of a company, placed a series of calls to securities analysts to alert them to bad news about the company; the alleged purpose of the disclosure was to protect and enhance the defendant's reputation. Without admitting or denying the Commission's allegations, the defendant consented to the entry of an injunction and an order requiring disgorgement of $126,455, representing the losses avoided by customers of two of the analysts who received material non-public information from him.

[Attachments A through N are retained in subcommittee files].

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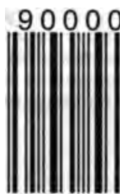

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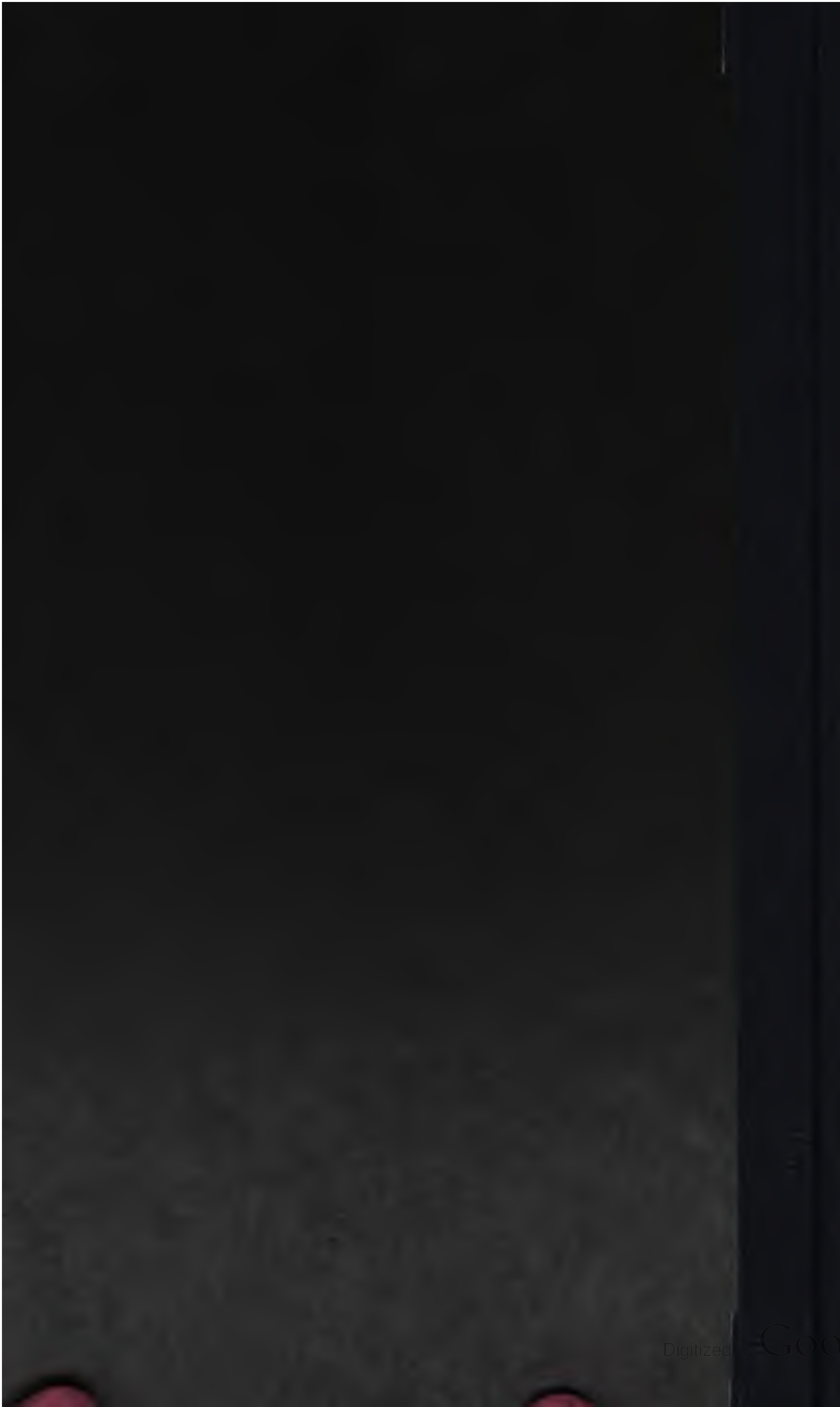

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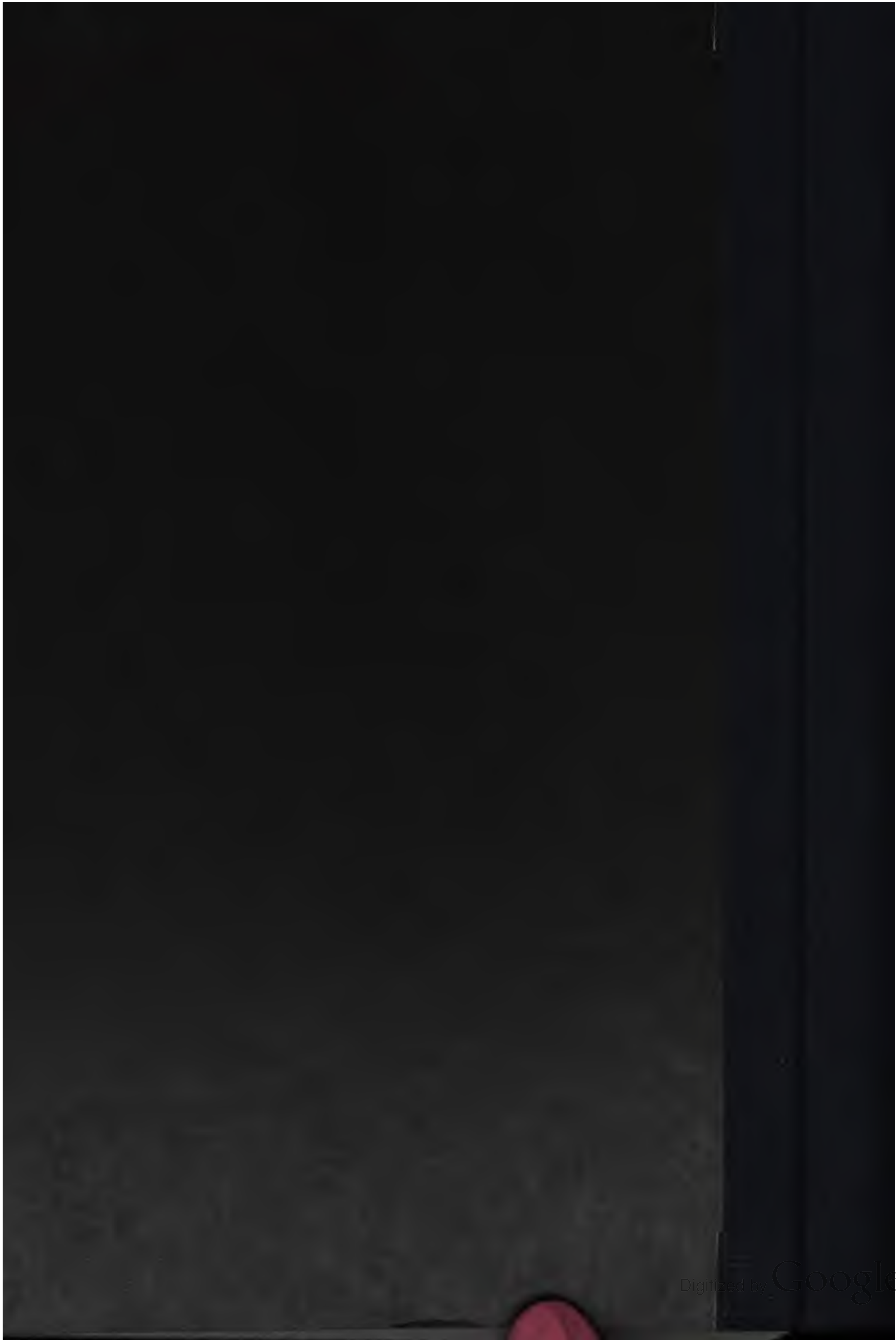

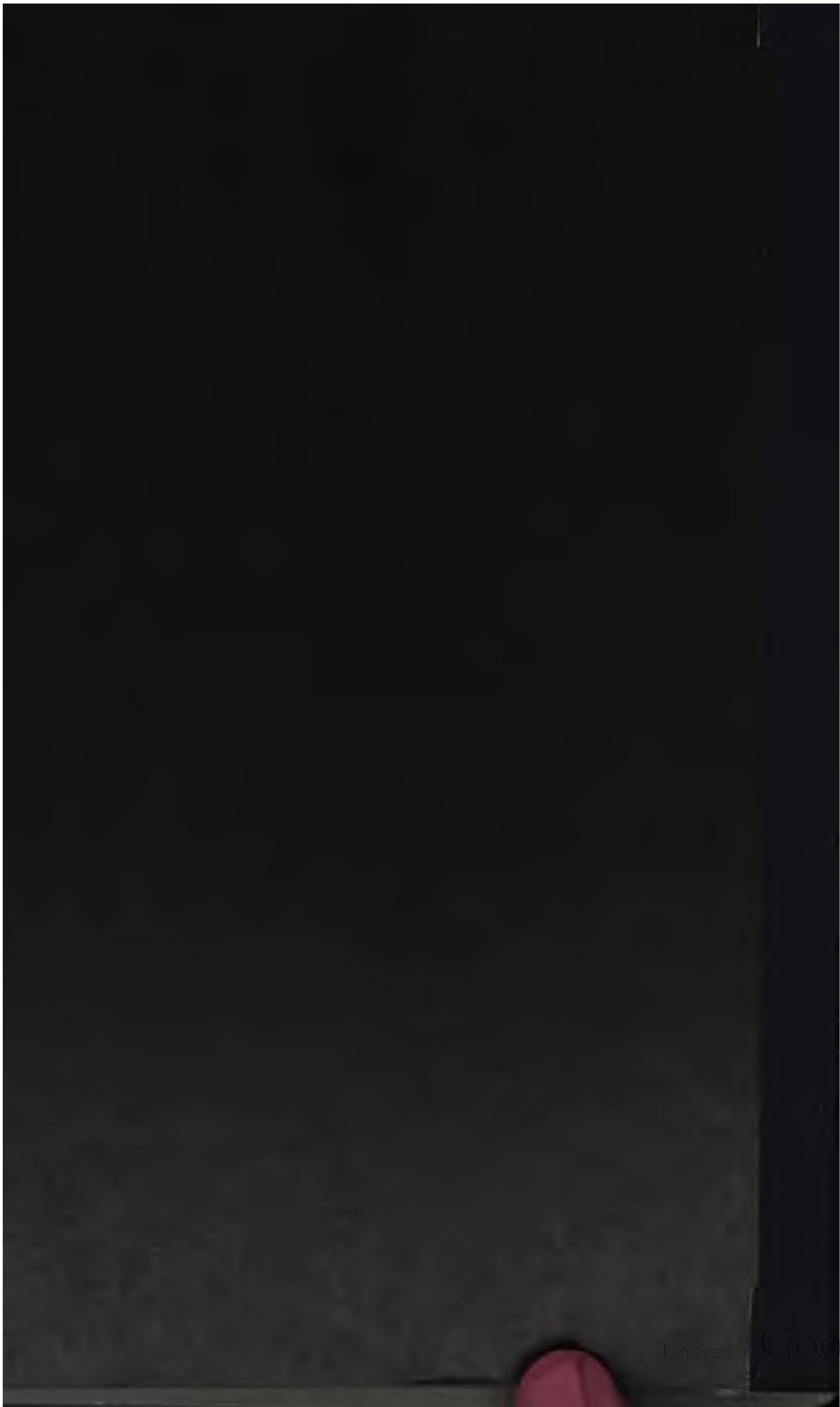
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